INTRODUCTION

The Federal Reserve shares supervisory and regulatory responsibility for domestic banks with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) at the federal level, and with individual state banking departments at the state level. The Federal Reserve is the primary federal supervisor of state-chartered banks that have chosen to join the Federal Reserve System. Such domestically operating banks are called state member banks (SMBs).

Regulation and supervision are distinct, but complementary, activities. Regulation entails establishing the rules within which financial institutions must operate—in other words, issuing specific regulations governing the formation, operations, activities, and acquisitions of financial institutions. Once the rules and regulations are established, supervision—which involves monitoring, inspecting, and examining financial institutions—seeks to ensure that an institution complies with those rules and regulations, and that it operates in a safe-and-sound manner.

Section 39 of the Federal Deposit Insurance Act[1] (FDI Act) requires each federal banking agency to establish certain safety-and-soundness standards by regulation or by guideline for all insured depository institutions. In accordance with section 39, the agencies' guidelines cover three types of standards: (1) operational and managerial standards; (2) compensation standards; and (3) such standards relating to asset quality, earnings, and stock valuation as they determine to be appropriate.[2] The safety-and-soundness standards that the agencies use to identify and address problems at insured depository institutions before capital becomes impaired. The agencies believe that the interagency standards for safety and soundness serve this end without dictating how institutions must be managed and operated. These standards are designed to identify potential safety-and-soundness concerns and ensure that action is taken to address those concerns before they pose a risk to the deposit insurance funds.

As the primary federal supervisor for SMBs (as well as bank holding companies, savings and loan holding companies, intermediate holding companies, and other banking entities), the Federal Reserve can take formal enforcement actions against these institutions for violations of laws, rules, or regulations, unsafe or unsound practices, breaches of fiduciary duty, and violations of final orders.

The purpose of this section is to describe key aspects of the Federal Reserve's supervisory program for safety-and-soundness examinations that are relevant to SMBs. Subsequent sections in this manual will further describe the examination and supervisory process of SMBs by supervisory portfolio, which is based on the banks' complexity, activities, asset size, and financial and operational risk factors.

EXAMINATION AND SUPERVISORY AUTHORITY

The Federal Reserve System's statutory examination authority permits examiners to review all books and records maintained by a financial institution that is subject to the Federal Reserve's supervision. This authority extends to all documents.[3] Section 11(a)(1) of the Federal Reserve Act provides that the Board has the authority to examine, at its discretion, the accounts, books, and affairs of each member bank and to require such statements and reports as it may deem necessary. Therefore, Federal Reserve supervisory staff (including examination staff), may review *all* books and records of a banking organization that is subject to Federal Reserve supervision.[4]

CONFIDENTIALITY PROVISIONS

The complete definition of confidential supervisory information (CSI) is in 12 CFR 261.2(c).61 Generally, CSI consists of any documents prepared by Federal Reserve staff that contains

1. 12 U.S.C. 1831p-1.
2. See 12 CFR 208, appendix D-1.

3. Supervision and Regulation SR-97-17, "Access to Books and Records of Financial Institutions During Examinations and Inspections," details the procedure supervisory staff should follow if a banking organization declines to provide information asserting a claim of legal privilege.
4. Supervisory staff include Federal Reserve staff who are conducting supervisory activities during the on-site examination and in connection with examination preparation, monitoring, and surveillance activities that are conducted off-site from a supervised institution's offices.

supervisory views regarding a supervised institution, or confidential information obtained from a supervised institution. These include examination reports, operating and condition reports (from continuous monitoring, for example), and information related to, derived for, or contained in such reports. Information gathered in the course of investigations related to enforcement actions is also CSI.

Importantly, CSI does not include "documents prepared by a supervised firm for its own business purposes and that are in its possession." (Refer to 12 CFR 261.2(c)(2).) This means that a supervised firm may share information that was submitted to the Federal Reserve with third parties so long as that information was not produced specifically for the Federal Reserve and does not contain any information that suggests supervisory views or supervisory actions communicated to the supervised firm by the Federal Reserve.

Under the Board's Rules Regarding the Availability of Information (12 CFR 261), banking organizations are prohibited from disclosing confidential supervisory information without prior written permission of the Board's General Counsel.[5] Board staff have taken the position that identification of information requested by, or provided to, supervisory staff—including the fact that an examination has taken or will take place—is related to an examination and falls within the definition of confidential supervisory information.

Confidentiality Provisions in Agreements that Prevent or Restrict Notification to the Federal Reserve

The Federal Reserve has stated and clarified its expectations regarding confidentiality provisions that are contained in agreements between a banking organization and its counterparties (for example, mutual funds, hedge funds, and other trading counterparties) or other third parties. It is contrary to Federal Reserve regulation and policy for agreements to contain confidentiality provisions that (1) restrict the banking organization from providing information to Federal Reserve supervisory staff (refer to 12 U.S.C. 1820(d)); (2) require or permit, without the prior approval of the Federal Reserve, the banking organization to disclose to a counterparty that any information will be or was provided to Federal Reserve supervisory staff; or (3) require or permit, without the prior approval of the Federal Reserve, the banking organization to inform a counterparty of a current or upcoming Federal Reserve examination or any nonpublic Federal Reserve supervisory initiative or action. Banking organizations that have entered into agreements containing such confidentiality provisions are subject to legal risk. See SR-07-19, "Confidentiality Provisions in Third-Party Agreements," and SR-97-17, "Access to Books and Records of Financial Institutions During Examinations and Inspections," for more information. For information on the restrictions pertaining to the very limited disclosure of confidential supervisory ratings and other nonpublic supervisory information, see SR-05-4, "Interagency Advisory on the Confidentiality of Nonpublic Supervisory Information," and SR-96-26, "Provision of Individual Components of Supervisory Rating Systems to Management and Boards of Directors."[6]

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:

- *Provides flexible and responsive supervision.* The supervisory process is dynamic and forward-looking, so 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 to market developments.
- *Fosters consistency, coordination, and communication among the appropriate supervisors.* Seamless supervision, which reduces regulatory burden and duplication, is promoted. Examiners review the institution's risk assessments, key control functions, and monitoring systems. Federal Reserve examiners conduct joint examinations with other federal banking agencies and alternate examinations with state bank supervisors. Examiners tailor

5. 12 CFR 261.20(g).

6. See also this manual's section, "Overall Conclusions Regarding Condition of the Bank."

supervisory activities to an institution's condition, risk profile, and unique characteristics.
- *Promotes the safety and soundness of financial institutions.* The supervisory process effectively evaluates the safety and soundness of banking institutions, including assessing risk-management systems and financial condition as well as determining compliance with laws and regulations.
- *Provides a comprehensive assessment of the institution.* The supervisory process integrates "specialty" areas (for example, information technology, trust, Bank Secrecy Act (BSA)/anti-money laundering (AML), and consumer compliance) and functional risk assessments and reviews, in cooperation with interested supervisors, into a comprehensive assessment of the institution.

RISK-FOCUSED EXAMINATIONS

The Federal Reserve began to further emphasize the importance of sound risk-management processes and strong internal controls in the mid-1990s when evaluating the activities of SMBs. (See SR-96-14, "Risk-focused Safety and Soundness Examinations and Inspections," and SR-95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies.") To ensure that institutions have in place the processes necessary to identify, measure, monitor, and control their risk exposures, Federal Reserve supervisory activities focus on evaluating the appropriateness of a bank's risk management practices and processes. Under a risk-focused examination approach, examiner resources are focused on a bank's highest risk areas. However, when examiners find weakness in a bank's risk-management processes or internal controls, such as an inadequate loan review function, examiners would increase the sample of loans to review or will perform additional loan transaction testing. In addition, if an examiner believes that a banking organization's management is being less than candid, has provided false or misleading information, or has omitted material information, then examiners will expand the scope of their on-site transaction testing.

The Federal Reserve recognizes that transaction testing by itself is not sufficient for ensuring the continued safe-and-sound operation of a banking organization. Evolving financial instruments and markets have enabled banking organizations to rapidly reposition their risk exposures. Therefore, periodic assessments of the condition of a financial institution that are based on transaction testing alone cannot keep pace with the moment-to-moment changes occurring in a bank's risk profile.

The examination approaches for both community banks and large banks are risk-focused processes that rely on an understanding of the institution, the performance of risk assessments, the development of a supervisory plan or examination scope, and examination procedures tailored to the institution's risk profile. However, the Federal Reserve has tailored its supervisory approach for a large bank versus a community bank. The process for large institutions relies more heavily on a dedicated supervisory team with central points of contact and supervisory plans consisting of various activities such as continuous monitoring activities, target reviews, or horizontal supervisory activities. In comparison, for community banks, the Federal Reserve conducts a point in time examination, which is supplemented by off-site surveillance monitoring. The Federal Reserve's supervisory approach differs for community banks versus larger more complex banks to address differences in banks' activities, operations, and risk profiles. In comparison to community banks, large complex banks typically have more financial products, sophisticated risk-management systems (including audit and internal controls), greater management structure, and a wider geographic dispersion of operations.

COMPLIANCE WITH LAWS AND REGULATIONS

Compliance with relevant laws and regulations should be assessed during the examination process. The steps taken to complete these assessments will vary depending on the circumstances of the institution subject to review. When an institution has a history of satisfactory compliance with relevant laws and regulations or has an effective compliance function, only a relatively limited degree of transaction testing need be conducted to assess compliance. At institutions with a less satisfactory compliance record or that lack a compliance function, more extensive review will be necessary.

Role of Supervisory Guidance

The Federal Reserve, FDIC, National Credit Union Administration (NCUA), OCC, and the Bureau of Consumer Financial Protection (collectively the "agencies") issue various types of supervisory guidance, including interagency statements, advisories, bulletins, policy statements, questions and answers, and frequently asked questions, to their respective supervised institutions. A statute or regulation has the force and effect of law.[7] Unlike a law or regulation, supervisory guidance does not have the force and effect of law, and the agencies do not take enforcement actions based solely on supervisory guidance. Rather, supervisory guidance outlines the agencies' supervisory expectations or priorities and articulates the agencies' general views regarding appropriate practices for a given subject area. Supervisory guidance often provides examples of practices that the agencies generally consider consistent with safety-and-soundness standards or other applicable laws and regulations, including those designed to protect consumers. See SR-18-5/CA-18-7, "Interagency Statement Clarifying Role of Supervisory Guidance."

APPLICATIONS UNDER REGULATION H: 12 CFR 208

Regulation H (12 CFR 208) defines the membership requirements for SMBs; describes membership privileges and conditions imposed on these banks; sets out procedures for requesting approval to establish branches and for requesting voluntary withdrawal from membership; provides information for registering and filing financial statements; sets out procedures for dealing with banks that are less than adequately capitalized; and establishes real estate lending standards. Below is description of various applications SMBs file under Regulation H.

Bank Merger

A bank must file an application for prior Federal Reserve approval under section 18(c) or section 5(d)(3) of the FDI Act to merge with another bank or thrift institution, respectively, or to acquire the assets, or assume the liabilities, of another bank or thrift institution, if the resulting institution is to be an SMB.

Bank Service Company

An SMB must file an application for prior Federal Reserve approval under section 5(a) of the Bank Service Company Act (BSC Act) to invest in or establish a bank service company if the company would engage in activities under sections 4(c), 4(d), or 4(e) of the BSC Act. A bank (regardless of its charter) must file an application for prior Federal Reserve approval under section 5(b) of the BSC Act to invest in or establish a bank service company if the company would engage in activities under sections 4(b) or 4(f) of the BSC Act.

Change in Control

A person or a group acting in concert, as defined in Regulation Y (12 CFR 225.2), proposing to acquire voting shares of an SMB may be required to provide prior notice to the Federal Reserve in accordance with Regulation Y (12 CFR 225.43).

Domestic Branches

An SMB must file an application for prior Federal Reserve approval under Regulation H (12 CFR 208.6) to establish a new branch facility. An application must be filed, whether the branch is located in the state where the bank is headquartered (intrastate branch) or whether the branch is located in another state (interstate branch). In addition, applications for de novo interstate branches are subject to state filing requirements and to capital, management, and community reinvestment standards. See SR-11-3, "De Novo Interstate Branching by State Member Banks." See also, SR-13-7/CA-13-4, "State Member Bank Branching Considerations."

Section 109 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the Interstate Act) (12 U.S.C. 1835a) prohibits any bank from establishing or acquiring a branch or branches outside of its home state primarily

7. Government agencies issue regulations that generally have the force and effect of law. Such regulations generally take effect only after the agency proposes the regulation to the public and responds to comments on the proposal in a final rulemaking document.

for the purpose of deposit production. In 1997, the banking agencies published a joint final rule implementing section 109. (See 62 *Fed. Reg.* 47728, September 10, 1997.) Section 106 of the Gramm-Leach-Bliley Act of 1999 expanded the coverage of section 109 of the Interstate Act to include any branch of a bank controlled by an out-of-state bank holding company. On June 6, 2002, the Board and the other banking agencies published an amendment to their joint final rule (effective October 1, 2002) to conform the uniform rule to section 109. (See 67 *Fed. Reg.* 38844.) The amendment expands the regulatory prohibition against interstate branches being used as deposit-production offices to include any bank or branch of a bank controlled by an out-of-state bank holding company, including a bank consisting only of a main office. See Regulation H, 12 CFR 208.7(b)(2).

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) modified the federal statute governing de novo interstate branching by SMBs. As a result, as of July 22, 2010, an SMB is authorized to open its initial branch in a host state[8] by establishing a de novo branch at any location at which a bank chartered by the host state could establish a branch.[9]

An SMB that desires to establish a new branch facility may be eligible for expedited processing of its application by the Reserve Bank if it is an eligible bank, as defined in Regulation H (12 CFR 208.2(e)).

A member bank also may choose to submit an application that encompasses multiple branches that it proposes to establish within one year of the approval date. Unless notification is waived, the bank must notify the appropriate Reserve Bank within 30 days of opening any branch approved under a consolidated application. The approval to open a branch is valid for one year. During this period, the Board or the appropriate Reserve Bank may notify the bank that in its judgment, based on reports of condition, examinations, or other information, there has been a change in the bank's condition, financial or otherwise, that warrants reconsideration of the approval. (See Regulation H, 12 CFR 208.6(d).)

Insured depository institutions that intend to close branches must comply with the requirements detailed in section 42 of the FDI Act (12 U.S.C. 1831r-1). Section 42(e) requires that banks provide 90 days' notice to both customers and, in the case of insured SMBs, the Federal Reserve Board before the date of the proposed branch closings. The notice must include a detailed statement of the reasons for the decision to close the branch, and statistical and other information in support of those stated reasons. A similar notice to customers must be posted in a conspicuous manner on the premises of the branch to be closed at least 30 days before the proposed closing. There are additional notice, meeting, and consultation requirements for proposed branch closings by interstate banks in low and moderate income areas. Finally, the law requires each insured depository institution to adopt policies for branch closings. (See the revised joint policy statement concerning insured depository institutions' branch closing notices and policies, effective June 29, 1999. See also 64 *Fed. Reg.* 34844.) Examiners and supervisors need to be mindful of the section 42 statutory requirements and this joint policy.

Regulation H (12 CFR 208.6(f)) states that a branch relocation, defined as a movement that occurs within the immediate neighborhood and does not substantially affect the nature of the branch's business or customers served, is not considered a branch closing. Further, Regulation H (12 CFR 208.2(c)(2)(ii)) states (in one of six exclusions) that a branch does not include an office of an affiliated or unaffiliated institution that provides services to customers of the member bank on behalf of the member bank, so long as the institution is not "established or operated" by the bank. For example, a bank could contract with an unaffiliated or affiliated institution to receive deposits; cash and issue checks, drafts, and money orders; change money; and receive payments of existing indebtedness without becoming a branch of that bank. The bank could also (1) have no ownership or leasehold interest in the institution's offices, (2) have no employees who work for the institution, and (3) not exercise any authority or control over the institution's employees or methods of operation.

8. "Host state" means a state, other than a bank's home state, in which the bank seeks to establish and maintain a branch. 12 U.S.C. 36(g)(3)(C).

9. 12 U.S.C. 36(g)(1)(A), as amended by section 613(a) of the Dodd-Frank Act; 12 U.S.C. 321. Initial entry into a host state by way of an interstate bank merger is governed by 12 U.S.C. 1831u.

Emergency Applications

Emergency conditions associated with a problem or failing banking organization may allow for processing of an application under the streamlined procedures of the Bank Holding Company Act, the FDI Act, the Change in Bank Control Act, or the Federal Reserve Act.[10] The two types of emergency procedures are expeditious action and immediate action. Under the expeditious action procedures, the Federal Reserve allows the public up to 10 days to comment on a proposal. Under the immediate action procedures, the Federal Reserve would act on a proposal as soon as possible. Potential filers are encouraged to contact the Federal Reserve as early as possible to discuss emergency procedures.

Membership

A state-chartered bank proposing to become a member of the Federal Reserve System or a national bank converting to a state-charter and desiring to remain a member of the Federal Reserve System must file an application for prior Federal Reserve approval under of Regulation H (12 CFR 208.3).[11] A bank seeking membership should contact the Federal Reserve prior to submitting a final application to allow for the completion of a pre-membership examination, if needed.

Notice of Addition or Change in Directors or Senior Executive Officers

An SMB must provide prior notice to the Federal Reserve to add a director or a senior executive officer if the bank meets the criteria in Regulation Y (12 CFR 225.72). An institution may request a waiver of the prior notice requirement if the individual's services are needed immediately.

10. Emergency procedures cannot be used without a letter from the chartering authority of the failing financial institution.

11. A newly organized bank must apply directly to the FDIC for deposit insurance. The bank also should have received at least preliminary approval for a state banking charter prior to filing a final membership application with the Federal Reserve. A draft application may be submitted prior to state action on the charter.

Premises Acquisition

An SMB must provide prior notice to the Federal Reserve under Regulation H (12 CFR 208.21) to increase its investment in bank premises if the aggregate of all such investments and loans, together with the amount of any indebtedness incurred by any corporation that is an affiliate of the bank, will be more than the bank's perpetual preferred stock and related surplus plus common stock and surplus. The filing threshold is raised to 150 percent of the bank's perpetual preferred stock and related surplus plus common stock and surplus if the proposal meets the conditions in Regulation H (12 CFR 208.21(a)(3)). See also this manual's section entitled, "Bank Premises and Equipment," for more information.

Changes in the General Character of a Bank's Business

In conjunction with assessing overall compliance with relevant laws and regulations, examiners should review for compliance with the requirements of Regulation H, which sets forth the requirements for membership of state-chartered banks in the Federal Reserve System and imposes certain conditions of membership on applicant banks. Under the regulation, a member bank must "at all times conduct its business and exercise its powers with due regard to safety and soundness" and "may not, without the permission of the Board, cause or permit any change in the general character of its business or in the scope of the corporate powers it exercises at the time of admission to membership." (See SR-02-9, "Guidance Regarding Significant Changes in the General Character of a State Member Bank's Business and Compliance with Regulation H," and Regulation H (12 CFR 208.3(d)(1) and (2)).)

SMBs must receive the prior approval of the Board before making any significant change in business plans. The trend toward more diverse, more complex, and, at times, riskier activities at some banks has raised the importance of this prior-approval requirement. Changes in the general character of a bank's business would include, for example, becoming a primarily financial technology-based operation, or concentrating solely on subprime lending, mortgage lending, or leasing activities. Depending on how they are conducted and managed, these activities can present novel risks for banking organizations and may also present risks to the deposit insurance fund. In many cases, these activities involve aggressive growth plans and may give rise to significant financial, managerial, and other supervisory issues.

In applications for membership in the Federal Reserve System, the Federal Reserve considers a bank's proposed business plan to ensure, at a minimum, that appropriate financial and managerial standards are met. Likewise, the other federal banking agencies consider a bank's business plan when they review applications for federal deposit insurance, in the case of the FDIC, or applications for a national bank or federal thrift charter, in the case of the OCC. The OCC and the FDIC may condition their approvals of applications on a requirement that, during the first three years of operations, the bank or thrift provides prior notice or obtains prior approval of any proposed significant deviations or changes from its original operating plan. Rather than use similar commitments, the Federal Reserve has relied on the provisions of Regulation H to address situations in which an SMB proposes to materially change its core business plan.

Federal Reserve supervisors should monitor changes in the general character of an SMB's business as part of the Federal Reserve's normal supervisory process to ensure compliance with the requirements of Regulation H and with safe-and-sound banking practices. This review should be conducted by the Reserve Bank during the on-site examination of the bank. A significant change in a bank's business plan without the Board's prior approval would be considered a violation of Regulation H and would be addressed through follow-up supervisory action.

Minimum Statewide Loan-to-Deposit Ratios

Section 109 of the Interstate Act sets forth a process to test compliance with the statutory requirements. First, a bank's statewide loan-to-deposit ratio[12] is compared with the host-state loan-to-deposit ratio[13] for banks in a particular state. If the bank's statewide loan-to-deposit ratio is at least one-half of the published host-state loan-to-deposit ratio, then it has complied with section 109 of the Interstate Act. A second step is conducted if a bank's statewide loan-to-deposit ratio is less than one-half of the published ratio for that state or if data are not available at the bank to conduct the first step. The second step involves determining whether the bank is reasonably helping to meet the credit needs of the communities served by its interstate branches. If a bank fails both of these steps, it has violated section 109 of the Interstate Act and is subject to sanctions.

RATING THE BANK

Uniform Financial Institutions Rating System

All of the federal banking agencies use the Uniform Financial Institutions Rating System (UFIRS), commonly referred to as the "CAMELS" rating system, as the criteria for rating a bank or thrift. The agencies under the auspices of the Federal Financial Institutions Examination Council (FFIEC) last revised this rating system in 1996. Under the UFIRS, each financial institution, more specifically an insured depository institution whose primary federal supervisory agency is represented on the FFIEC, is assigned a composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations. These component factors address the "C"—adequacy of capital; "A"—the quality of assets; "M"—the capability of management; "E"—the quality and level of earnings; "L"—the adequacy of liquidity; and "S"—the sensitivity to market risk.[14]

Evaluations of the components take into consideration the institution's asset size and sophistication, the nature and complexity of its activi-

12. The statewide loan-to-deposit ratio relates to an individual bank and is the ratio of a bank's loans to its deposits in a particular state where the bank has interstate branches.

13. The host-state loan-to-deposit ratio is the ratio of total loans in a state to total deposits from the state for all banks that have that state as their home state. For state-chartered banks, the home state is the state where the bank was chartered.

14. For a full description of the CAMELS component, see the manual section entitled, "Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System and the Federal Reserve's Risk Management Rating."

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

The composite rating generally bears a close relationship to the component ratings assigned. However, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors comprising that component and its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the financial institution. Assigned composite and component ratings are disclosed to the institution's board of directors and senior management.

The ability of management to respond to changing circumstances and to address the risks that may arise from changing business conditions, or the initiation of new activities or products, is an important factor in evaluating a financial institution's overall risk profile and the level of supervisory attention warranted. For this reason, the management component is given special consideration when assigning a composite rating. The ability of management to identify, measure, monitor, and control the risks of its operations is also taken into account when assigning each component rating. It is recognized, however, that appropriate management practices vary considerably among financial institutions, depending on their size, complexity, and risk profile. For less complex institutions engaged solely in traditional banking activities and whose directors and senior managers, in their respective roles, are actively involved in the oversight and management of day-to-day operations, relatively basic management systems and controls may be adequate. At more complex institutions, on the other hand, detailed and formal management systems and controls are needed to address their broader range of financial activities and to provide senior managers and directors, in their respective roles, with the information they need to monitor and direct day-today activities. All institutions are expected to properly manage their risks. For less complex institutions engaging in less sophisticated risk taking activities, detailed or highly formalized management systems and controls are not required to receive strong or satisfactory component or composite ratings.

Risk Management Rating

The Federal Reserve instituted an explicit risk management rating requirement to be assigned for examinations and inspections commencing on or after January 2, 1996. The risk management rating applies to all SMBs, regardless of their size.[15]

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:

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

The risk management rating should be reflected in the overall "Management" rating of the institution and should be consistent with the ratings criteria discussed in the section entitled, "Condition of the Bank: Uniform Financial Institutions Rating System."

Definition of a Full-Scope Examination

The definition of a full-scope examination includes the safety-and-soundness components of the Interagency Uniform Rating System for CAMELS, the safety-and-soundness mandates of the Federal Deposit Insurance Corporation Improvement Act of 1991 and other regulatory priorities. A full-scope examination involves the collection and analysis of data sufficient to allow the examiner-in-charge (EIC) to determine a

15. This rating requirement was introduced by SR-95-51. See also SR-16-11 and the manual section entitled, "Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System" and the Federal Reserve's Risk Management Rating.

rating for each of the CAMELS components. To make this determination the EIC should ensure various financial and managerial factors are considered during the full-scope examination. It is expected that a full-scope examination would be conducted on a consolidated basis, meaning that all subsidiaries of the bank would be evaluated. The scope of analysis of subsidiaries and the necessity for on-site presence in such subsidiaries and branches of the banking institution should be determined by the EIC after an analysis of the materiality and operational risk inherent in each. In most cases, an on-site examination of material credit extending (issuing) subsidiaries should be conducted. For more information on the minimum expectations for full-scope examinations see SR-94-12, "The Federal Reserve System's Definition of a Full Scope, On-Site Examination for Safety and Soundness."

Target Examinations

Target examinations focus intensively on one or two activities rather than assessing all of the safety-and-soundness components of the CAMELS rating system. There are multiple circumstances when the Federal Reserve would conduct a target examination. For instance, if the bank is under a formal enforcement action, compliance with the formal action may be validated, in part, through a target examination. In addition, the Federal Reserve may conduct a target examination of a particular activity, such as the bank's loan review, between full-scope examinations if off-site monitoring noted deteriorating asset quality at the bank. For more information, see discussion below on SMB examination frequency and coordination.

OTHER EXAMINATION AREAS

Foreign branch and specialty examination findings and the ratings assigned to those areas are taken into consideration, as appropriate, when assigning component and composite ratings under UFIRS. Several specialty examination areas include Compliance, Community Reinvestment, Government Security Dealers, Information Systems, Municipal Security Dealers, Transfer Agent, and Trust.[16]

EXAMINATION-FREQUENCY EXPECTATIONS FOR STATE MEMBER BANKS

The Federal Reserve is required to conduct a full-scope, on-site examination of every insured SMB at least once during each 12-month period, with the exception that certain small institutions can be examined once during each 18-month period. The 18-month examination period can be applied to those banks that

- have total assets of less than $3 billion;
- are well capitalized;
- the Federal Reserve assigned a management component rating of "1" or "2" at the most recent Federal Reserve or applicable state banking agency examination;[17]
- were assigned a CAMELS composite rating of "1" or "2" as part of the bank's rating;[18]
- are not subject to a formal enforcement proceeding or action by the Federal Reserve or the FDIC; and
- no person acquired control of the bank during the preceding 12-month period in which a full-scope examination would have been required but for the 18-month examination cycle eligibility provision.[19]

The exceptions do not limit the authority of the Federal Reserve to examine any insured member bank as frequently as deemed necessary. The examination cycle was also expanded from 12 months to 18 months for U.S. branches

16. See the manual section entitled "Other Examination Areas" for more information on the specialty examination areas.

17. The Board is permitted to conduct on-site examinations of SMBs on alternating 12-month or 18-month periods with the institution's state supervisor, if the Board determines that the alternating examination conducted by the state carries out the purposes of section 10(d) of the FDI Act. 12 U.S.C. 1820(d)(3). Refer to the discussion below on the Alternate-Year Examination Program.

18. The ratings were assigned under the Uniform Financial Institutions Rating System (UFIRS). Refer to SR-96-38, "Uniform Financial Institutions Rating System," and this manual's section entitled, "Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System and the Federal Reserve's Risk Management Rating."

19. 12 CFR 208.64.

and agencies of foreign banks, subject to specified qualifying criteria. (Refer also to SR-18-7, "Updates to the Expanded Examination Cycle for Certain State Member Banks and U.S. Branches and Agencies of Foreign Banking Organizations."

Bank Secrecy Act/Anti-Money Laundering Examination Frequency

The Federal Reserve is required to complete a BSA/AML compliance program review at each safety-and-soundness examination conducted at an SMB or U.S. branch or agency of a foreign bank, which is typically every 12 months.[20] However, Reserve Banks should conduct a BSA/

20. 12 U.S.C. 1818(s)(2) and 12 U.S.C. 1818(b)(4).

Table 1. Overview of State Member Bank Examination Frequency and Coordination[1]

<table>
<tr><th>Total Asset Size of the State Member Bank (SMB)[2]</th><th>Composite CAMELS rating of "1" or "2" from the last examination</th><th>Composite CAMELS rating of "3" from the last examination</th><th>Composite CAMELS rating of "4" or "5" from the last examination</th></tr>
<tr><td>$0 to less than $3 billion</td><td>Full-scope on-site exam every 18 months, provided:
• SMB is well capitalized;
• SMB received a CAMELS composite rating of "1" or "2" and a management component rating of "1" or "2" at the most recent Federal Reserve or applicable state banking agency examination;
• SMB not subject to a formal enforcement proceeding or order by Federal Reserve or FDIC; and
• No person acquired control of the SMB during the preceding 12-month period in which a full-scope exam would have been required but for the 18-month exam cycle.
Otherwise, full-scope on-site exam every 12 months.
May be eligible for alternate-year examination program (AEP).[3]</td><td rowspan="2">Full-scope on-site exam every 12 months conducted by the Federal Reserve or jointly with the relevant state banking agency. A targeted exam conducted by the Federal Reserve or jointly with the state banking agency is also required annually for deteriorating institutions.[4]</td><td rowspan="2">Two exams are required every 12 months. One of the two exams must be a full-scope exam. Both exams must be conducted by the Federal Reserve or jointly with the relevant state banking agency.</td></tr>
<tr><td>$3–$10 billion</td><td>Full-scope on-site exam every 12 months. May be eligible for AEP.</td></tr>
<tr><td>Greater than $10 billion and less than $100 billion</td><td colspan="3">Full-scope on-site exam every 12 months. Some SMBs rated CAMELS composite "1" and "2" may be eligible for an AEP. The SMB is subject to continuous monitoring, and exam activities are intensified based on the severity of issues at the bank.</td></tr>
<tr><td>$100 billion and above</td><td colspan="3">Full-scope on-site exam every 12 months. The full-scope exam must be led by the Federal Reserve and may be joint with the relevant state banking agency. The SMB is subject to continuous monitoring, and exam activities are intensified based on the severity of issues at the bank.</td></tr>
</table>

1. This table provides a brief summary of examination (exam) frequency requirements for SMBs. See the Federal Reserve Board's Regulation H, (12 CFR 208.64(b)).

2. Examinations of SMBs with more than $10 billion are typically integrated into the consolidated supervision program at the bank holding company.

3. AEPs generally allow exams conducted in alternating years or alternating 18-month periods, as appropriate, to be conducted by the state banking agency. For those SMBs with total assets over $3 billion, there must be a Federal Reserve examiner presence at state-led AEP exams. AEPs are implemented on a state-by-state basis. Consult the appropriate Reserve Bank for further information regarding eligibility and availability of an AEP in a particular state.

4. The Federal Reserve typically identifies deteriorating banks through off-site surveillance information. See this manual's section entitled, "Federal Reserve System Bank Surveillance Program," for more information.

AML compliance program review every 18 months if the SMB or U.S. branch or agency of a foreign bank is eligible for and is examined on the 18-month examination cycle. See SR-18-7 for more information.

De Novo Bank Examination Frequency and Scope

A de novo bank is a bank that has been in operation for three years or less. A de novo bank or a recently converted SMB has a different examination frequency from the required 12-month or 18-month examination schedule. The examination frequency for these banks is found in SR-20-16, "Supervision of De Novo State Member Banks."[21]

Within the first six months following a de novo's formation or conversion to a state member bank, the responsible Reserve Bank should conduct a targeted examination. In a written report provided to the bank's board of directors and senior management, the Reserve Bank should summarize the scope of review and supervisory findings but should generally not assign a CAMELS rating.

The responsible Reserve Bank should conduct a full-scope examination, independently, jointly, or concurrently with the state banking department within 12 months of the de novo's formation or its conversion to a state member bank. Thereafter, the bank should remain on a 12-month cycle until two full-scope, on-site examinations have been conducted. After the bank (1) has had three full-scope examinations, and (2) has been in operation for three years, the Reserve Bank may transition to the statutorily required full-scope examination schedule.

After the initial target examination, the next three examinations of the de novo, either led by the Federal Reserve or conducted jointly with the state banking department, should be full-scope. In addition to the supervisory expectations for a full-scope examination, the Reserve Bank should review the de novo for certain capital and managerial related items, which are outlined in SR-20-16.

De Novo Subsidiaries of Bank Holding Companies with Assets Greater than $3 Billion

A Reserve Bank may elect to make a risk-based determination that a de novo that is a subsidiary of a bank holding company with consolidated assets of greater than $3 billion should be examined less frequently than otherwise suggested in SR-20-16 if, in the opinion of the Reserve Bank, the parent company and its subsidiary banks are in satisfactory condition and the parent is considered to be a source of strength to its insured depository institution subsidiaries. Such subsidiary de novos would be expected to maintain capital levels that align with the de novo policy guideline outlined in SR-20-16.

EXAMINATION OF INSURED DEPOSITORY INSTITUTIONS PRIOR TO MEMBERSHIP OR MERGER INTO STATE MEMBER BANKS

A safety-and-soundness or consumer compliance examination of a state nonmember bank, national bank, or savings association seeking to *convert its status to a state member* will not generally be required prior to the conversion if the institution seeking membership meets the criteria for "eligible bank," as set forth in the Board's Regulation H,[22] plus the additional safety-and-soundness and consumer compliance criteria listed below (together referred to as "eligibility criteria").[23] To meet the Regulation H "eligible bank" criteria, an insured depository institution must

1. be well capitalized under Regulation H, subpart D, Prompt Corrective Action;

21. SR-20-16 applies to any commercial bank, thrift, Edge Act corporation, or industrial bank that has been in existence for less than three years and is converting to become a state member bank. Insured depository institutions that are in operation for longer than three years and apply to become a state member bank are not covered in SR-20-16 but may be subject to a pre-membership examination as outlined in SR-15-11/CA-15-9, "Examinations of Insured Depository Institutions Prior to Membership or Merger into a State Member Bank."

22. 12 CFR 208.2(e).

23. Note that a bank may be subject to a consumer compliance pre-membership or pre-merger examination or CRA review even if it meets all waiver eligibility criteria for safety-and-soundness examination. Similarly, a pre-membership or pre-merger safety-and-soundness examination may be warranted even though the bank meets all of the waiver criteria for consumer compliance and/or CRA.

2. have a composite CAMELS rating of "1" or "2";
3. have a Community Reinvestment Act (CRA) rating of "outstanding" or "satisfactory";
4. have a consumer compliance rating of "1" or "2"; and
5. have no major unresolved supervisory issues outstanding (as determined by the Board or appropriate Federal Reserve Bank in its discretion), including adverse supervisory findings or ratings by the current primary regulator or Consumer Financial Protection Bureau (CFPB).[24]

In addition, the insured depository institution seeking membership must meet the following additional safety-and-soundness criteria:

- the management component of CAMELS is rated "1" or "2"
- the on-site "close date" of the most recent full-scope safety-and-soundness examination is less than nine months from the date of the application for membership[25]
- there have been no material changes to the bank's business model since the most recent report of examination and no material changes are planned for the next four quarters[26]
- the annual growth in total assets, measured as of the most recent quarter end on the institution's Consolidated Reports of Condition and Income, is under 25 percent and planned growth over the next year is less than 25 percent

In cases where a state nonmember bank, national bank, or savings association is *merging with an SMB* and the surviving institution is an SMB, a safety-and-soundness or consumer compliance examination of the state nonmember bank, national bank, or savings association will not be required so long as the SMB meets all of the eligibility criteria on an existing and pro-forma basis. For example, the SMB would not meet all of the eligibility criteria if its total assets were to increase by 25 percent or more on a pro-forma basis considering both organic growth and assets from the merging institution. Other examples of situations that may cause the merging SMB to not meet the eligibility criteria include, but would not be limited to, a change in senior leadership, a change in strategy, and a situation where the institution with which it is merging is rated less than satisfactory, has major unresolved supervisory issues, or brings new business lines or products to the SMB. (See SR-15-11/CA-15-9, "Examinations of Insured Depository Institutions Prior to Membership or Merger into a State Member Bank.")

Process for Determining Whether to Waive a Safety-and-Soundness Examination

In all cases, the Reserve Bank must consult with Board supervisory staff when determining whether to waive a safety-and-soundness examination under this policy. Under certain circumstances, a pre-merger or pre-membership examination may be waived even when an institution fails to meet one or more of the safety-and-soundness related eligibility criteria. This can occur if the Reserve Bank, in consultation with Board supervisory staff, determines that conducting a safety-and-soundness examination would be unlikely to provide information that would assist in evaluating the statutory and regulatory factors that the Federal Reserve is required to consider in acting on the membership or merger application.

Process for Determining Whether to Waive a Consumer Compliance Examination or CRA Review

For consumer compliance and CRA, the Reserve Bank should review the most recent supervisory information, including consumer compliance examinations, reviews, and risk assessments, from the appropriate primary banking regulatory agency and the CFPB, if applicable, and consult

24. In general, if significant trust or fiduciary activities were found to be conducted in a less-than-satisfactory manner, an insured depository institution would typically not meet this requirement.

25. The close date of an on-site examination is defined as the last date that the examination team is physically on-site at the institution. For examinations for which all or a portion of the work is performed off-site, the close date is defined as the earlier of the following dates: (1) the date when the analysis (including loan file review) is completed and ready for the examiner-in-charge review; or (2) the date when the preliminary exit meeting is held with management, which can be conducted either on-site or off-site by conference call.

26. A "material change" would be an event that would materially affect the institution's balance sheet and income statement, such as a sizeable growth, sale, or wind-down of a major business line or assets, or change in senior leadership positions, such as the chief executive officer, the chief financial officer, or the chairman of the board.

with applications staff and supervisory staff in the Board's Division of Consumer and Community Affairs (DCCA) when determining whether to waive a consumer compliance examination under this policy. However, if the institution seeking to convert to an SMB is rated less-than-satisfactory for consumer compliance, a pre-membership or pre-merger examination should be conducted.

In addition, if the review of supervisory information from the appropriate primary banking regulatory agency and the CFPB, if applicable, identifies significant weaknesses, a pre-membership or pre-merger consumer compliance examination may be warranted, with a focus on the particular area of concern, even if a bank has a consumer compliance examination rating of "1" or "2."[27] In such cases, the Reserve Bank should also consult with applications and supervisory staff in DCCA.

Because membership in the Federal Reserve System does not confer deposit insurance, CRA does not, by its terms, apply to membership applications. Nevertheless, a less-than-satisfactory CRA rating, especially if it reflects a chronic record of weak CRA performance, would presumably reflect unfavorably upon the abilities of management of the institution. In these situations, it is appropriate for the Reserve Bank to include in the pre-membership examination a review of the institution's CRA performance as well as management's plans and programs to ensure that the organization meets its CRA obligations going forward.

Documentation Requirement for a Waived Safety-and-Soundness or Consumer Compliance Examination

The Reserve Bank must prepare and maintain documentation supporting its decision not to conduct a pre-membership or pre-merger safety-and-soundness or consumer compliance examination. Documentation should include a memorandum summarizing how the institution meets each of the eligibility criteria or a justification for the waiver for cases where the institution does not meet one or more of the eligibility criteria. The supporting memorandum should summarize the Reserve Bank's review of the two most recent full-scope safety-and-soundness and consumer compliance examinations conducted by the appropriate primary banking regulatory agency and, when applicable, the CFPB.

27. Supervisory matters not captured in the examination rating could raise significant concerns that may warrant a pre-membership or pre-merger examination. Examples of such events that could raise serious concerns about consumer compliance include (1) a continuous monitoring event; (2) litigation; (3) investigations by other agencies, such as the Department of Justice, or the Department of Housing and Urban Development; and (4) other information—such as a spike in consumer complaints.

Scope and Documentation of the Safety-and-Soundness or Consumer Compliance Examination

All pre-membership or pre-merger safety-and-soundness or consumer compliance examinations can be risk focused and targeted, as appropriate, to the identified area(s) of weakness. Furthermore, the Reserve Bank is not required to issue a report to the institution; however, the review should be documented in a memorandum that is maintained together with the application documents.

To fulfill the examination requirement for an insured depository institution or savings association that is a subsidiary of a bank holding company or savings and loan holding company (hereafter referred to as holding company) with consolidated assets equal to or greater than $100 billion, the supervisory team will generally rely on information gathered through the existing continuous monitoring program. The team is also expected to consider findings from recent examinations that assessed specific risks, lines of business, or control functions, and from reviews such as the Comprehensive Capital Analysis and Review, the mid-cycle supervisory stress test for banks and holding companies, the holding company resolution plans, and the insured depository institution resolution plan. In the event the results of continuous monitoring and prior examinations do not provide the information necessary to assess specific areas of weakness, the supervisory team will conduct a targeted examination.

Supervisory Expectations Post-Merger or Charter Conversion

In all cases, the Reserve Bank remains responsible for adhering to the required frequency timeframes established by Federal Reserve policies and regulations for both safety-and-soundness and consumer compliance examinations. When the statutory deadline for the examination of an insured depository institution seeking membership is approaching, or has passed, a Reserve Bank should conduct an examination of the institution as soon as is practical after it becomes an SMB. The Reserve Bank should notify Board supervisory staff if the examination mandate will be missed for whatever reason.

In addition, for institutions with $10 billion or more in total consolidated assets, the Reserve Bank should complete the risk assessments and supervisory strategies required for safety-and-soundness no later than 30 days after the conversion or merger, regardless of whether the institution met the eligibility criteria. In preparing the risk assessment and supervisory strategy for an SMB that was formerly a savings association or that acquired a savings association, the Reserve Bank should pay particular attention to activities conducted by any service corporation subsidiary that may not be permissible for an SMB, where such activities have not yet been conformed.[28]

COORDINATION OF SUPERVISORY ACTIVITIES: COORDINATION WITH OTHER BANKING AGENCIES

Alternate-Year Examination Program

The frequency of examination also may be affected by the AEP. Under the AEP, those banks that qualify are examined in alternate examination cycles by the Reserve Bank and the state. Thus, a particular bank would be examined by the Reserve Bank in one examination cycle, the state in the next, and so on. Any bank may be removed from the program and examined at any time by either agency, and either agency can meet with a bank's management or board of directors or initiate supervisory action whenever deemed necessary. In general, banks with assets in excess of $10 billion and banks that are rated a composite 3 or worse are ineligible for an alternate-year examination. De novo state member banks are also ineligible for the AEP for the first three years of operations. (See SR-20-16.) For an SMB that has undergone a change in control and the state is scheduled to conduct the next examination, a Federal Reserve examiner should participate on the state-led AEP examination.

Guidelines for Relying on State Examinations

In 1995, the Federal Financial Institutions Examination Council (FFIEC) announced the adoption of Guidelines for Relying on State Examinations pursuant to section 349 of the Riegle Community Development and Regulatory Improvement Act of 1994.[29] One of the main reasons for issuing this guidance was to establish standards for the purpose of determining the acceptability of state reports of examination under section 10(d)(3) of the FDI Act, 12 U.S.C. 1820(d)(3).

The Federal banking agencies will accept and rely on state reports of examination in all cases in which it is determined that state examinations enable the federal banking agencies to effectively carry out their supervisory responsibilities. The following criteria may be considered, in whole or in part, by a federal banking agency when determining the acceptability of a state report of examination under section 10(d) of the FDI Act:

- The completeness of the state examination report. The state report of examination of a state-chartered, insured depository institution or a state-chartered branch or agency of a foreign bank should contain sufficient information to permit a reviewer to make an independent determination on the overall condition of the institution as well as each component factor and composite rating assigned under the "Uniform Financial Institutions Rating System" used for insured depository institutions and commonly referred to as the "CAMELS" rating system or the "ROCA"

28. The Board, in acting on a membership application, is required to consider whether the corporate powers to be exercised are consistent with the purposes of the Federal Reserve Act (12 U.S.C. 322). In addition, Regulation H (12 CFR 208.3(d)(2)) requires a state member bank to obtain the Board's permission prior to changing the scope of powers it exercises.

29. 12 U.S.C. 1820(d)(9).

rating system used for branches and agencies of foreign banks.

- The adequacy of documentation maintained routinely by state examiners to support observations made in examination reports.
- The ability over time of a state banking department to achieve examination objectives. At a minimum, the federal banking agencies will consider the adequacy of state budgeting, examiner staffing and training, and the overall review and follow-up examination process of a state banking department. Accreditation of a state banking department by the Conference of State Bank Supervisors is among the factors that also will be considered.
- The adequacy of any formal or informal arrangement or working agreement between a state banking department and a federal banking agency.

The Federal banking agencies, as part of their routine review of state examination reports, will assess the quality and scope of the reports to determine whether they continue to meet the above general criteria. The Federal banking agencies retain the option in cases in which a state examination report appears insufficient or the condition of an insured institution, as indicated in the examination report or other sources, appears to be seriously deteriorating, to conduct a follow-up examination.

The appropriate Federal banking agency and state banking department will continue to share, discuss and work to resolve any problems or concerns regarding the acceptability of each other's work or the operation of these guidelines and the alternating examination program as well as other issues of mutual interest.

Ratings Assigned by State Supervisory Agencies under the Alternate Examination Program

Reserve Banks should review all state examination reports on banks included in the AEP. A Reserve Bank should only assign a separate CAMELS rating if there is disagreement with the rating assigned by the state supervisory agency that conducted the examination. In the event that a rating disparity exists, the rating assigned by the Reserve Bank and the rationale for that rating must be communicated to the board of directors of the affected institution and to the appropriate state and federal supervisory agencies.

The rating assigned by the state supervisory agency that conducted the examination should be entered into Federal Reserve systems of record as a full-scope examination. A different rating assigned by the Reserve Bank in connection with the AEP examination should be recorded as an "examination" event with a "supervisory assessment activity" scope. The Federal Reserve rating will serve as the basis for determining compliance with relevant statutes and regulations, and for the conduct of supervisory responsibilities, including supervisory and enforcement activities, the frequency of inspection/examination activity, and general surveillance activity. See SR-99-17, "Supervisory Ratings for State Member Banks, Bank Holding Companies and Foreign Banking Organizations, and Related Requirements for the National Examination Data System," for more information.

Joint Examination Guidelines

The Nationwide State/Federal Supervisory Agreement, dated November 14, 1996, which addresses the supervision of multistate banking organizations, established guidelines for the conduct of joint examinations. Under the terms of the agreement, the participating state and federal supervisory agencies should make every effort to resolve significant differences that arise during a joint examination. If differences cannot be resolved, the agreement permits each supervisory agency to take action, independent of the other, in the fulfillment of its own statutory and supervisory responsibilities.

An examination should be considered a joint examination only if the participating supervisory agencies agree on the component and composite ratings to be assigned. If the Federal Reserve and the state supervisory agency disagree on the ratings to be assigned, the examination should be termed "concurrent," and should be recorded as such in the appropriate Federal Reserve system of record. In these instances, both the Federal Reserve rating and the state supervisory agency rating should be entered into the appropriate Federal Reserve system of record. In the event that an examination changes from "joint" to "concurrent" in the course of the examination, the examining Reserve Bank must assign a separate supervisory rating and issue a separate report of examination. The Federal Reserve rating will serve as the basis for determining compliance with relevant statutes and regulations, and for the conduct of its supervisory responsibilities, including supervisory and enforcement activities, the frequency of inspection/examination activity, and general surveillance activity.

Supervision of State-Chartered Banks

In May 2004, the State-Federal Working Group, an interagency group of state bank commissioners and senior officials from the Federal Reserve and the FDIC, developed a recommended-practices document designed to reiterate and reaffirm the need for a commonsense approach for collaborating with states in the supervision of state-chartered banking organizations.[30] The recommended practices highlight the importance of communication and coordination between state and federal banking agencies in the planning and execution of supervisory activities.

When communicating and coordinating with other agencies, examination and supervisory staff should follow the common courtesies and recommended practices identified in the May 2004 document. The recommended practices reinforce the long-standing commitment of federal and state banking supervisors to provide efficient, effective, and seamless oversight of state banks of all sizes, whether those institutions operate in a single state or more than one state. The recommended practices also minimize, to the fullest extent possible, the regulatory burden placed on state-chartered banks—thus further supporting and fostering a seamless supervisory process. (See SR-04-12, “Supervision of State-Chartered Banks.”)

30. The source for the recommended practices is the November 14, 1996, Nationwide State and Federal Supervisory Agreement to enhance the overall state-federal coordinated supervision program for state-chartered banks. The agreement established a set of core principles to promote coordination in the supervision of all interstate banks, with particular emphasis on complex or larger institutions. (See SR-96-33, “State/Federal Protocol and Nationwide Supervisory Agreement.”) These principles are equally applicable and important when supervisors from federal and state banking agencies are communicating and coordinating the supervision of state-chartered banks operating within a single state.

Recommended Practices for State Banking Departments, the FDIC, and the Federal Reserve

1. State and federal banking agencies should take steps to ensure that all staff responsible for the supervision and examination of state-chartered banks are familiar with the principles contained in the agreement. State and federal banking agencies should ensure that adherence to the principles in the agreement is communicated as a priority within their respective agencies at all levels of staff—ranging from the field examiners to the officers in charge of supervision and to state bank commissioners.
2. Home-state supervisors should make every effort to communicate and coordinate with host-state supervisors as an important part of supervising multistate banks as specified in the Nationwide Cooperative Agreement executed by the state banking departments and recognized by the federal agencies in the agreement.
3. State and federal banking agencies should consider inviting one another to participate in regional examiner training programs and/or seminars to discuss emerging issues and challenges observed in the banking industry.
4. Federal and state banking departments should maintain and share current lists of their staff members designated as primary contact persons (PCPs) for their institutions.
5. PCPs and EICs from the state banking department(s) and federal agencies should discuss and prepare supervisory plans at least once during the examination cycle, and more frequently as appropriate for institutions of greater size or complexity or that are troubled. The agencies should discuss and communicate changes to the plan as they may evolve over the examination cycle. The supervisory plans should be comprehensive, including examination plans, off-site monitoring, follow-up or target reviews, supervisory actions, etc., as applicable.
6. The PCPs from the home-state banking department and federal banking agencies should make every effort to share reports that their individual agencies have produced through their off-site monitoring program or through targeted supervisory activities.

7. State and federal banking agencies should notify one another as early as possible if their agency cannot conduct a supervisory event (e.g., examination) that was previously agreed upon—or if the agency intends to provide fewer examiners/resources than originally planned.
8. Meetings with bank management and directors should involve both the appropriate staff from the home-state banking department and from the responsible federal banking agency, whenever possible. If a joint meeting is not possible or appropriate (for example, the bank arranges the meeting with one agency only), the other agency (the home-state banking department or the responsible federal banking agency, as applicable) should be informed of the meeting.
9. The home-state and responsible federal agency should make every effort to issue a joint exam report in the 45-day time frame identified in the agreement. If circumstances prevent adherence to time frames identified in the agreement, the state and federal agencies should coordinate closely and consider benchmarks or timing requirements that may apply to the other agency.
10. All corrective action plans (for example, memoranda of understanding (MOU), cease-and-desist orders) should be jointly discussed, coordinated, and executed to the fullest extent possible among all examination parties involved. Also, all information on the institution's corrective action plan and progress made toward implementing the plan should be shared.
11. To ensure that messages to management are consistent to the fullest extent possible, supervisory conclusions or proposed actions should only be communicated to bank management, the bank board of directors, or other bank staff after such matters have been fully vetted within and between the federal banking agency and home-state banking department. The vetting process should, to the fullest extent possible, adhere to the exit meeting and examination report issuance time frames specified in the agreement. All parties should make every effort to expedite the process in order to deliver timely exam findings and efficient regulatory oversight.
12. When differences between the agencies arise on important matters, such as examination conclusions or proposed supervisory action, senior management from the home-state banking department and the appropriate federal banking agency should communicate to try to resolve the differences. In the event that the state and federal banking agency cannot reach agreement on important matters affecting the supervised institution, the respective agencies should coordinate the communication of those differences to the management or board of directors of the supervised institution, including the timing thereof and how the differing views will be presented. (See SR-99-17.)

Coordinating Activities with the Consumer Financial Protection Bureau

On May 16, 2012, the CFPB, the Federal Reserve Board, the FDIC, the NCUA, and the OCC entered into an MOU to facilitate the fulfillment of the agencies' responsibilities in a manner consistent with the provisions of sections 1022, 1024, and 1025 of the Dodd-Frank Act. The MOU covers depository institutions with more than $10 billion in total assets. The objectives of the MOU, among other things, are to establish which examination schedules must be coordinated, which examinations must be conducted simultaneously, what it means to conduct an examination simultaneously, and how insured depository institutions may request to opt out of simultaneous examinations.[31]

COORDINATION OF SUPERVISORY ACTIVITIES: COORDINATION ACTIVITIES AMONG THE RESERVE BANKS

Many large banks have interstate operations; therefore, 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 (RRB) with the cen-

31. For more information, see the Board's June 4, 2012, press release at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20120604a.htm.

tral point of contact or the local Reserve Bank (LRB).

The RRB is accountable for all aspects of the supervision of a fully consolidated banking organization, which includes the supervision of all the institution's subsidiaries and affiliates (domestic, foreign, and Edge corporations) for which the Federal Reserve has supervisory oversight responsibility. The RRB is generally expected to work with LRBs in conducting examinations and other supervisory activities, particularly where significant banking operations are conducted in a local District. Thus, for SMBs, the LRB has an important role in the supervision of that subsidiary. However, the RRB retains authority and accountability for the results of all examinations and reviews that an LRB may perform on its behalf. See SR-05-27/CA-05-11, "Responsible Reserve Bank and Inter-District Coordination."

Responsible Reserve Bank

In general, the RRB for a banking institution has been the Reserve Bank in the District where the banking operations of the organization are principally conducted. For domestic banking institutions, the RRB typically will be the Reserve Bank District where the head office of the top-tier institution is located and where its overall strategic direction is established and overseen. For foreign banking institutions, the RRB typically will be the Reserve Bank District where the Federal Reserve has the most direct involvement in the day-to-day supervision of the U.S. banking operations of the institution.

When necessary, the Board's Division of Supervision and Regulation (S&R), in consultation with DCCA, may designate an RRB when the general principles set forth above could impede the ability of the Federal Reserve to perform its functions under law, do not result in an efficient allocation of supervisory resources, or are otherwise not appropriate.

Duties of RRBs

The RRB develops the consolidated supervisory plan and ensures that the scope and timing of planned activities conducted by participating Districts and agencies pursuant to the plan are appropriate. The RRB designates the central point of contact or lead examiner and ensures that all safety-and-soundness, information technology, trust, consumer compliance, Community Reinvestment Act (CRA), and other specialty examinations, inspections, and visitations are conducted and appropriately coordinated within the System and with other regulators. In addition, the RRB manages all formal communications with the foreign and domestic supervised entity, including the communication of supervisory assessments, ratings, and remedial actions.[32]

Sharing of RRB Duties

To take advantage of opportunities to enhance supervisory effectiveness or efficiency, an RRB is encouraged to arrange for the LRB to undertake on its behalf certain examinations or other supervisory activities. For example, an LRB may have relationships with local representatives of the institution or local supervisors; leveraging these relationships may facilitate communication and reduce costs. Additionally, LRBs may provide specialty examination resources—in the case of CRA examinations, LRB staff often provide valuable insights into local communities and lending institutions that should be factored into the CRA assessment. When other Reserve Bank Districts conduct examinations and other supervisory activities for the RRB, substantial reliance should be placed on the conclusions and ratings recommended by the participating Reserve Bank(s).

The RRB retains authority and accountability for the results of all examinations and reviews performed on its behalf and, therefore, must work closely with LRB examination teams to ensure that examination scopes and conclusions are consistent with the supervisory approach and message applied across the consolidated organization. If an LRB identifies major issues in the course of directly conducting supervisory activities on behalf of an RRB, those issues should be brought to the attention of the RRB in a timely manner.

If an RRB arranges for an LRB to conduct supervisory activities on its behalf, the LRB is responsible for the costs of performing the activities. If the LRB is unable to fulfill the request from the RRB to perform the specified activities, the RRB should seek System assis-

32. See SR-96-33.

tance, if needed, by contacting Board staff or using other established procedures for coordinating resources.

In general, LRBs are responsible for the direct supervision of SMBs located in their district. LRBs and host states will not routinely examine branches of SMBs or issue separate ratings and reports of examination. Similar to the relationship between the RRBs and LRBs, home-state supervisors[33] will coordinate the activities of all state banking departments and will be the state's principal source of contact with federal banking agencies and with the bank itself. Also, host states will not unilaterally examine branches of interstate banks. Close coordination among the Reserve Banks and other appropriate regulators for each organization is critical to ensure a consistent, risk-focused approach to supervision.

COMMUNICATION OF SUPERVISORY FINDINGS

This subsection on the "Communication of Supervisory Findings" is based on the guidance in SR-13-13/CA-13-10, "Supervisory Considerations for the Communication of Supervisory Findings," which applies to all Federal Reserve-supervised banking organizations. In a supervisory finding, examiners should convey, if evident, both the root cause of the finding and the potential effect of the finding on the organization. Examiners should also consider the guidance in SR-18-5/CA-18-7, "Interagency Statement Clarifying the Role of Supervisory Guidance," for more information on the communication of supervisory findings, including the appropriate identification of unsafe or unsound practices or other deficiencies in risk management, including compliance risk management, or other areas that do not constitute violations of law or regulation.

Communication of supervisory findings to the organization's board of directors is an important part of the supervision of a banking organization. While the board itself may not directly undertake the work to remediate supervisory findings as senior management is responsible for the organization's day-to-day operations, it is nevertheless important that the board be made aware of significant supervisory issues and ultimately be accountable for the safety and soundness and assurance of compliance with applicable laws and regulations of the organization.

Depending upon the size and complexity of the organization, supervisory findings are communicated in writing through formal examination or inspection reports, reports summarizing the results of targeted reviews, a roll-up of those reviews into a comprehensive report, any other supervisory communication, or some combination thereof. These written communications (referred to collectively as "reports" in this section) are generally directed to the board of directors, or an executive-level committee of the board[34] as appropriate. In turn, the board of directors (or executive-level committee of the board) typically will direct the organization's management to take corrective action and will provide management with appropriate oversight, including approvals of proposed management actions as necessary.

To be effective, the communication of supervisory findings must be (1) written in clear and concise language, (2) prioritized based upon degree of importance, and (3) focused on any significant matters that require attention.

Reserve Banks must formally communicate Matters Requiring Immediate Attention (MRIAs) and Matters Requiring Attention (MRAs) resulting from any supervisory activity to the organization in these written reports. In order to promote an understanding of these terms, examiners should include definitions of MRIAs and MRAs in all supervisory documents communicating supervisory findings.[35] When included in a safety-and-soundness examination or inspection report, MRIAs and MRAs should be listed in the "Matters Requiring Attention" section. In the case of findings from consumer compliance examinations, MRIAs and MRAs should be reflected in the "Executive Summary and Examination Ratings" section of the consumer

33. The 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.

34. An executive-level committee of the board (such as, the audit committee or risk committee) typically meets regularly, keeps minutes of those meetings, and is accountable to and routinely reports to the board of directors.

35. In a safety-and-soundness report, these definitions could be included on the "Scope" page, in an appendix, or as a footnote on the "Matters Requiring Attention" section. In a consumer compliance report, these definitions could be included on the "Executive Summary and Examination Ratings" section.

affairs report of examination. Only outstanding MRIAs and MRAs are required to be discussed in the report; however, examiners have discretion to discuss closed MRIAs and MRAs in the report if such discussion would be meaningful.

For large banking organizations, an annual roll-up report summarizes the significant findings, based on outstanding MRIAs or MRAs, included in the reports of targeted reviews or other supervisory activities conducted during the supervisory cycle. These findings may be grouped by major supervisory issues, rating components, risks, or themes. This information should enable the banking organization's board of directors and any executive-level committee of the board to understand the substance and status of outstanding MRIAs or MRAs and focus their attention on the most critical and time-sensitive issues.

Communications to banking organizations concerning safety-and-soundness or consumer compliance MRIAs or MRAs must specify a timeframe within which the banking organization must complete the corrective actions. In certain circumstances, examiners may require the banking organization to submit an action plan that identifies remedial actions to be completed within specified timeframes. Action plans with intermediate- and long-term timeframes that span more than one supervisory or examination cycle with regard to safety-and-soundness matters, or a 12-month period with regard to consumer compliance issues, should include interim progress targets. Both safety-and-soundness and consumer protection or compliance considerations will remain a priority in determining whether the organization's timeframes to correct the matter are reasonable.

Matters Requiring Immediate Attention

MRIAs arising from an examination, inspection, or any other supervisory activity are matters of significant importance and urgency that the Federal Reserve requires banking organizations to address immediately and include (1) matters that have the potential to pose significant risk to the safety and soundness of the banking organization; (2) matters that represent significant noncompliance with applicable laws or regulations; (3) repeat criticisms that have escalated in importance due to insufficient attention or inaction by the banking organization; and (4) in the case of consumer compliance examinations, matters that have the potential to cause significant consumer harm. An MRIA will remain an open issue until resolution and examiners confirm the banking organization's corrective actions.

Required language. Federal Reserve examiners are expected to use the following standardized language to communicate MRIAs to the board of directors (or executive-level committee of the board):

"The board of directors (or executive-level committee of the board), or banking organization *is required to immediately..."*

Timeframe. The expected timeframe for a banking organization to address MRIAs is generally short, and may be "immediate," in the case of heightened safety-and-soundness or consumer compliance risk. For MRIAs that are necessary to preserve or restore the viability of a banking organization, the timeframe should take into account any potential losses to the FDIC's Deposit Insurance Fund, including the possibility that a delay in action will increase the potential for loss or the cost of resolution.

Organization response. Following its review of MRIAs discussed in the report, the banking organization's board of directors is required to respond to the Reserve Bank in writing regarding corrective action taken or planned along with a commitment to corresponding timeframes.

Supervisory follow-up. The Reserve Bank must follow up on MRIAs to assess progress and verify satisfactory completion. The timeframe for follow-up should correspond with the timeframe specified for the action being required, and should be appropriate for the severity of the matter requiring the corrective action. The means of follow-up may vary depending upon the nature and severity of the matter requiring the action. Follow-up may take the form of a subsequent examination, a targeted review, or any other supervisory activity deemed suitable for evaluating the issue at hand.

In some cases, when follow-up indicates the organization's corrective action has not been satisfactory, the initiation of additional formal or informal investigation or enforcement action may be necessary. In such cases, examiners should consult with enforcement staff.[36] In all instances, examiners are expected to exercise judgment as to the supervisory activities best suited for evaluating a particular issue. Once follow-up is completed, examiners are expected to clearly and fully document the rationale for their decision to close any issue. Examiners are also expected to communicate in writing the results of their work and findings to the banking organization.

Matters Requiring Attention

MRAs constitute matters that are important and that the Federal Reserve is expecting a banking organization to address over a reasonable period of time but when the timing need not be "immediate." While issues giving rise to MRAs must be addressed to ensure the banking organization operates in a safe-and-sound and compliant manner, the threat to safety and soundness is less immediate than with issues giving rise to MRIAs. Likewise, consumer compliance concerns that require less immediate resolution should be communicated as an MRA. An MRA typically will remain an open issue until resolution and confirmation by examiners that the banking organization has taken corrective action. If a banking organization does not adequately address an MRA in a timely manner, examiners may elevate an MRA to an MRIA. Similarly, a change in circumstances, environment, or strategy can also lead to an MRA becoming an MRIA. The key distinction between MRIAs and MRAs is the nature and severity of matters requiring corrective action as well as the immediacy with which the banking organization must begin and complete corrective actions.

Required language. Federal Reserve examiners are expected to use the following standardized language to communicate MRAs to the board of directors (or executive-level committee of the board):

"The board of directors (or executive-level committee of the board), or banking organization *is required to...*"

Timeframe. Communications to banking organizations about MRAs must specify a timeframe within which the corrective action is expected to be completed. The timeframe, at least initially, may require estimation because the banking organization may first need to complete preliminary planning to establish the timeframe for initiating and completing the corrective action. The timeframes for MRAs are likely to become more precise over time as planning evolves and circumstances make the completion of the MRAs more urgent. Timeframes that span more than one examination cycle for safety-and-soundness issues or that exceed 12 months for consumer compliance issues should include appropriate interim progress reports.

Organization response. Following its review of the report, the banking organization's board of directors is required to provide a written response to the Reserve Bank regarding its plan, progress, and resolution of the MRA.

Supervisory follow-up. The Reserve Bank must follow-up on MRAs to assess progress and verify satisfactory completion. The timeframe for follow-up should correspond with the timeframe during which actions are to be completed. For intermediate- or long-term corrective actions for MRAs, Reserve Bank follow-up may consist of assessing the organization's progress to address the MRAs, whether satisfactory or unsatisfactory, and noting whether the initial estimated timeframe continues to be reasonable or warrants adjustment.

The means of supervisory follow-up may vary based upon the nature and severity of the matter for which corrective action is expected. Follow-up may take the form of a subsequent examination, targeted review, continuous monitoring, reliance on validation work conducted by internal audit function, reliance on the results of examinations conducted by other supervisors, or any other supervisory activity deemed suitable for evaluating the issue at hand.[37]

36. Such consultation should be made in accordance with existing guidance to Reserve Bank supervisory staff on the processing of enforcement actions, which provides that recommendations concerning formal enforcement actions should be submitted to the Board's Legal Division.

37. Examiners may choose to rely on the work of internal audit when internal audit's overall function and related processes are effective, as discussed in SR-13-1/CA-13-1, "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing." (See this manual's section entitled "Internal Control and Audit Function, Oversight, and Outsourcing.") When relying on internal audit to follow up on MRAs, examiners are expected to review the relevant work papers and, when necessary, meet with internal audit staff who documented the resolution of the issue.

In some cases, when follow-up indicates the organization's corrective action has not been satisfactory, the initiation of additional formal or informal investigation or enforcement action may be necessary. In all instances, examiners are expected to exercise judgment regarding the supervisory activities best suited for evaluating a particular issue. Once follow-up is complete, examiners are expected to clearly and fully document the rationale for their decision to close any issue. Examiners also are expected to communicate in writing the results of their work and findings to the organization.

Supervisory Considerations

The volume of MRIAs and MRAs should be one of the many considerations in assigning a supervisory rating to a banking organization. The presence of a large number of MRIAs or MRAs may indicate that additional formal or informal investigation may be necessary or that the initiation of a formal or informal enforcement action may be warranted.

Irrespective of the number of MRIAs or MRAs, in some cases, additional formal or informal investigation may be necessary or the initiation of a formal or informal enforcement action may be warranted based on the severity of the issues, the repeat nature of issues, lack of responsiveness of management, violations of law, insider abuse, fraud, or other material deficiency. In any of these cases, examiners should consult with the Board's enforcement staff.

Factors in Escalating Issues into Enforcement Actions

The volume of open MRIAs and MRAs and the materiality of the issues therein to the safety and soundness of the banking organization are important overarching considerations in determining whether examiners need to consult with the Board's enforcement staff in escalating issues into enforcement actions.[38] In addition to the guidance presented in SR-13-13/CA-13-10, examiners should consider the following key factors in determining whether to recommend additional formal or informal investigation or enforcement action:

- the organization's supervisory ratings and financial condition;[39]
- whether the issues involve unsafe or unsound practices, violations of laws, noncompliance with regulations, insider abuse, fraud, or other material deficiencies;[40]
- the severity or repetitive or intentional nature of the issues;
- management's willingness and ability to correct the issues;
- management's history of instituting timely remedial or corrective actions;
- whether management already initiated corrective action or established procedures to prevent future deficiencies;
- whether criminal or other regulatory authorities are taking a formal enforcement or prosecutorial action against the same institution;
- the organization's history of violations of laws, noncompliance with regulations and unsafe and unsound unsatisfactory practices; and
- any other circumstances that warrant use of an enforcement action.

As described in this manual's section, "Formal and Informal Supervisory Actions," it is important for examiners and supervision staff to provide adequate support for all recommendations for both formal and informal actions in the examination report and associated workpapers.

Revising Supervisory Ratings

Supervisory ratings should be revised whenever there is strong evidence of significant changes to the bank's financial or operational condition.[41] It is important that supervisory ratings reflect a current assessment of an institution's financial condition and risk profile, as the ratings can affect risk-based deposit insurance premiums, statutory and regulatory requirements, including applications and the prompt corrective action provisions of the FDI Act, and supervisory

38. Issues are considered closed if the banking organization implements and examiners verify and validate the effectiveness of the corrective action, or if the organization's practices are no longer a concern because of a change in the organization's circumstances.

39. See SR-96-38, "Uniform Financial Institutions Rating System."

40. See 12 U.S.C. 1818(b)(1).

41. See SR-99-17, "Supervisory Ratings for State Member Banks, Bank Holding Companies and Foreign Banking Organizations, and Related Requirements for the National Examination Data System."

reporting and examination requirements as well as other factors. While supervisory ratings are most frequently revised as a result of on-site supervisory activities, other sources of information reviewed off-site may also indicate the need for a rating change.[42]

In addition, when a component of one of the supervisory rating systems is changed, the Reserve Bank must also reaffirm or revise the other component ratings and the composite rating, based upon available information at that time. The factors contributing to a change in the rating of a selected component can affect one or more of the other components in the rating system as well as the composite rating. Accordingly, if there is a compelling reason to change a selected component rating, all of the other components in the supervisory rating system must be either reaffirmed or revised. As applicable for holding companies and SMBs, the risk management rating must also be reaffirmed or revised when a CAMELS or holding company rating is changed.

Any change to a component or composite rating and the rationale for that change must be communicated in writing via a letter or report to the board of directors of the affected institution (or to the senior U.S. management official in the case of a U.S. branch, agency, office, or nonbank subsidiary of a foreign bank) and to the appropriate state and federal supervisory agencies. When ratings are revised between scheduled Federal Reserve examinations and inspections, the revised rating should be entered into the appropriate Federal Reserve system of record.

REPORTS OF EXAMINATION

As mentioned above, depending upon the size and complexity of the organization, supervisory findings are communicated in writing in a number of ways. In general, a community bank receives a comprehensive report based on the findings from its statutorily mandated examination every 12 or 18 months. Historically, the agencies promoted consistency in the communication of examination findings by mandating certain pages in the report of examination. In 2019, the FFIEC members agreed on a set of principles that should apply to the completion of all reports of examination. The FFIEC members determined that a principles-based approach for completing the report of examination would better achieve the objectives of promoting consistency and communication amongst the agencies, while allowing individual supervisors the flexibility to document their assessment of financial institutions of different sizes, activities, risk profiles, and financial and managerial condition. See SR-19-6, "Federal Financial Institutions Examination Council Policy Statement on the Principles for Completing the Report of Examination," for more information. For more information on the structure of the report of examination and timing expectation for completing reports of examination, see this manual's section entitled, "Community Bank Supervision Process."

Larger SMBs with greater than $10 billion in assets are generally examined as part of the continuous monitoring and inspection activities of the parent bank holding company. While the Federal Reserve is required to conduct a full-scope, on-site examination of these larger SMB at least once during each 12-month period, the scale and frequency of monitoring activities that inform this rating differs by institution. As such, the format of supervisory letters or examination reports for larger banks varies depending on the scope and subject matter examiners review. For larger SMBs, the Federal Reserve typically delivers the results of the annual SMB full-scope examination and CAMELS rating in the same letter as the bank holding company annual assessment.

Combined Reports

Reserve Banks may issue a combined report for a bank holding company and its lead SMB subsidiary when (1) a bank holding company's lead bank subsidiary is an SMB and (2) the holding company's board formally approves the release of a combined report to its lead SMB subsidiary. In cases where the company has more than one SMB, separate examination reports should be prepared for all other SMB subsidiaries. The Reserve Bank should send a letter to a qualified holding company that ex-

42. For example, significant change in financial condition may be evident from some combination of reports of examination conducted by other agencies, meetings or other communication with management of the institution, published financial reports or press releases, status reports submitted by the institution as required by an enforcement action, and information generated by ongoing surveillance activities.

plains its option of receiving a combined report. If the holding company's board wishes to receive a combined report, it should formally approve the release of the combined report to its lead SMB subsidiary by board resolution. (See SR-94-46, "Combined Examination/Inspection Report For Bank Holding Companies With Lead State Member Banks," and its attachment.)

Timing Standards for Completing Reports

Specific expectations for examination staff to complete the examination report vary depending on factors such as the size of the bank, the condition of the bank, and the level of supervisory coordination for a particular examination. In general, examination staff are expected to complete reports more promptly for SMBs that are poorly rated than SMBs that are in satisfactory condition. The manual sections discussing the supervisory programs of the various portfolios provide more detailed information on timing expectations for completing and sending examination reports to supervised institutions.

ENFORCEMENT ACTIONS

Generally, formal or informal enforcement actions are taken after the completion of an on-site bank examination. These examinations include commercial, trust, electronic data-processing, consumer, or other types of examinations. Formal or informal enforcement actions may also be taken when a Reserve Bank becomes aware of a problem at a bank that warrants immediate attention and correction.

When a bank's deficiencies are severe, uncorrected, repeat, or unsafe or unsound, or negatively affect the bank's condition, the Board may issue a formal action to correct practices. The Board is required to publish and make publicly available any final order issued for any administrative enforcement proceeding it initiates. These orders include cease-and-desist, removal, prohibition, and civil money penalty assessments.

Informal supervisory actions are used when circumstances warrant a less severe form of action than the formal supervisory actions described above. Informal actions are not enforceable and their violation cannot serve as a basis for assessing a civil money penalty or initiating a removal and prohibition action. Informal actions are not published or publicly available. These informal actions include commitments, Board resolutions, and MOUs. For more information, see this manual's section entitled, "Formal and Informal Supervisory Actions."

APPEALS PROCESS

In general, questions about or objections to supervisory determinations made during the course of an inspection or examination are most effectively handled through the longstanding Federal Reserve practice of resolving any problems informally during the course of the inspection or examination process. If problems cannot be resolved through the inspection or examination process, the Board has developed guidelines that implement the intra-agency appeals process required by section 309 of the Riegle Community Development and Regulatory Improvement Act of 1994. One of the key aspects of the appeals process developed under section 309 is the establishment of the Ombudsman who

1. acts as a liaison between the agency and any affected person with respect to any problem such party may have in dealing with the agency resulting from the regulatory activities of the agency; and
2. ensures that safeguards exist to encourage complainants to come forward and preserve confidentiality

In March 2020, the Board revised its internal appeals process for institutions wishing to appeal an adverse material supervisory determination and its policy regarding the Ombudsman for the Federal Reserve System. See 85 *Federal Register* 15,175 (March 17, 2020) and the Board's website for more information on the appeals process and the Ombudsman Policy Statement.

INTRODUCTION

Community banks constitute the largest number of state member banks (SMBs) supervised by the Federal Reserve System. For community banks, the primary purpose of prudential regulation is to ensure the safety and soundness of each individual institution, thereby protecting the deposit insurance fund. The Federal Reserve scales or risk-focuses its supervisory expectations based on the size, risk profile, condition, and complexity of a bank and its activities.

DEFINITION OF A COMMUNITY BANKING ORGANIZATION

For supervisory purposes, the Federal Reserve uses the term “community bank” to generally describe a bank with $10 billion or less in total consolidated assets and “community banking organization” generally to describe an SMB or holding company with $10 billion or less in total consolidated assets.

RISK-FOCUSED SUPERVISION OF COMMUNITY BANKS

The risk-focused methodology for the supervision program for community banks reflects a continuous and dynamic process. The objective of a risk-focused examination is to effectively evaluate the safety and soundness of the bank, including the assessment of its risk management systems, financial condition, and compliance with applicable laws and regulations. In addition, the risk-focused supervision process of community banks aims to align resource requirements for examinations with the risks inherent in the bank’s activities. Examiner judgment is another key element in effectively determining the initial scope of state member bank examinations.

The Federal Reserve has developed technological tools for examiners to improve the efficiency of both off-site and on-site supervisory activities. The goal of these measures is to facilitate greater consistency and more efficient, effective, and risk-focused examinations by better enabling staff to tailor the scope of examinations to the activities and risks of individual banks. The automation of various parts of the community bank examination process save examiners and bankers time, as a bank can submit requested pre-examination information electronically. Through these efforts, the Federal Reserve aims to strike an appropriate balance between off-site and on-site supervisory activities to ensure that community banks are subject to supervision that is both high-quality and resource-efficient.

The risk-focused methodology consists of several steps, each of which uses certain written products to facilitate communication and coordination.

Steps	***Products***
Understanding the bank	Institutional Overview
Assessing the bank’s risk	Risk tiering or preliminary risk assessment
Defining examination activities	Scope memorandum Entry letter
Performing examination procedures	Risk-focused examination procedures from the Examination Documentation (ED) modules
Reporting the findings	Report of examination

Understanding the Bank

Institutional Overview

The risk-focused supervision process for community banks involves an assessment of the bank that enables examiners to tailor their examination to the bank’s risk profile. In addition to examination reports and correspondence files, surveillance reports identify outliers when a bank is compared to its peer group. Review of this information helps examiners identify a bank’s strengths and vulnerabilities, and is the foundation for determining the examination activities to be conducted.

The institutional overview should contain a concise executive summary that demonstrates 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. General types of information that may be valuable to present in the overview include

- a brief description of the organizational structure;
- a summary of the organization's business strategies as well as changes in key business lines, growth areas, new products, etc., since the prior review;
- an overview of the board of directors, management, and corporate governance;
- a brief analysis of the consolidated financial condition and trends;
- descriptions of internal and external audit;
- risk assessment matrix;
- overview of risk management including key risk types (credit, market, liquidity, operational, legal, and compliance);
- key issues for the organization, either from external or internal factors;
- a description of the future prospects of the organization;
- a summary of supervisory activity performed since the last review;
- considerations for conducting future examinations; and
- the ability to conduct loan review off-site.

Assessing the Institution's Risks: Risk Tiering, Scoping, and Preliminary Risk Assessment

A bank's business activities present various combinations and concentrations of the noted risks depending on the nature and scope of the particular activity. Therefore, when assessing the bank's risks, 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.

The Federal Reserve uses financial metrics to help differentiate the level of risk between banks before examinations.[1] This helps examiners tailor examination expectations and procedures, which are discussed in the scope memorandum. For community SMBs, the scope of an examination work program for a particular risk dimension depends on a bank's risk classification, as follows:

- *High risk.* High risk means that under unfavorable market conditions, the bank's activities for a particular risk dimension often lead to adverse outcomes. Examiners apply the full extent of examination procedures and conduct additional work, as necessary, including independent verification and transaction testing, to reach, support, and document conclusions regarding the level of an SMB's risk exposure and the adequacy of management's efforts to mitigate and manage risk.[2]
- *Moderate risk.* Moderate risk means that in unfavorable markets, the bank's activities for a particular risk dimension occasionally result in adverse outcomes. Examiners apply a subset of examination procedures, with a focus on evaluating an SMB's key risk drivers and financial reports in order to confirm that risk is moderate. Independent examiner verification and transaction testing are applied to specific areas but reduced relative to high-risk areas.
- *Low risk.* Low risk means the expected incidence of adverse outcomes for a particular risk dimension is low, irrespective of market conditions. Examiners apply a smaller subset of examination procedures for low-risk areas than for moderate-risk areas, with a focus on evaluating an SMB's key risk drivers and financial reports in order to confirm that risk is low. Independent examiner assessment of risk management is reduced relative to moderate-risk cases.

Supervisory teams design the risk-aligned work programs for each risk dimension, resulting in procedural templates for general use in the examination process. For a given risk dimension, the degree of differentiation between low-, moderate-, and high-risk work programs directly depends, in part, on the predictive capacity of the risk dimension's surveillance metrics, as confirmed via back testing.

At each examination, the examiner-in-charge (EIC) confirms the risk classifications upon which planned work programs were based and, if needed, adjusts or expands the work pro-

1. See this manual's section entitled, "Federal Reserve System Bank Surveillance Program," for more information, and SR-19-9, "Bank Exams Tailored for Risk (BETR)."

2. The procedures that examiners perform for each examination area should focus on developing appropriate documentation to assess management's ability to identify, measure, monitor, and control risk.

grams. If initial discussions with management or additional information obtained during the examination indicate significant weaknesses in an SMB's risk management or higher than anticipated risk, examiners are expected to alter an examination's scope and associated work programs and appropriately document the modifications in examination work papers.

All work programs should continue to include the review and verification of corrective action taken to address any outstanding Matters Requiring Immediate Attention (MRIA) or Matters Requiring Attention (MRA).

DEFINING EXAMINATION ACTIVITIES

Scheduling the Examination

Contact with the bank is encouraged to improve the examiners' understanding of the institution and the market in which it operates. A pre-examination interview or visit should generally be conducted as a part of each full-scope examination. This meeting gives examiners the opportunity to determine whether there have been any changes in bank management and changes to the bank's policies, strategic direction, management information systems, and other activities. During this meeting, particular emphasis should be placed on learning about the bank's new products or new markets it may have entered. The pre-examination interview or visit also provides examiners with (1) management's view of local economic conditions, (2) an understanding of the bank's regulatory compliance practices, and (3) its management information systems and internal and/or external audit function. In addition, Reserve Banks should contact the state banking supervisor to determine whether it has any special areas of concern where the examiners should focus.

In addition to obtaining an understanding of the institution, Reserve Bank examination staff contacts community bank management prior to an on-site examination in order to provide bank management adequate time to plan for the examination and address logistical issues for the on-site examination team. The EIC, or a designee, should contact bank management 8 to 12 weeks prior to the start date of the examination in order to communicate the proposed examination start and close dates and ensure that bank management and key bank staff are available during the proposed dates. Contacting the bank with the appropriate lead time allows examiners and bank management to reschedule certain supervisory activities if there are conflicts with previously scheduled regulatory, audit, or loan reviews. At that time, bank management may also request that examiners review loan files off-site and make the necessary arrangements for Reserve Bank staff to obtain the technical information necessary to confirm that the bank can support an off-site review. See SR-16-8, "Off-site Review of Loan Files."

Scope Memorandum

As an integral product in the Federal Reserve's risk-focused methodology, the scope memorandum identifies the central objectives of the examination. The memorandum also ensures that the examination strategy is communicated to appropriate examination staff, which is of key importance, as the scope will likely vary from examination to examination. Examination procedures are tailored to the characteristics of each bank, keeping in mind its size, complexity, and risk profile. Procedures should be completed to the degree necessary to determine whether the bank's management understands and adequately controls the levels and types of risk that are assumed. In addition, the scope memorandum should address the general banking environment, economic conditions, and any changes foreseen by bank management that could affect the bank's condition. Some of the key factors that should be addressed in the scope memorandum are described below.

- *Summary of Pre-Examination Meeting.* The results of the pre-examination meeting, which is discussed above, should be summarized. Examiners should appropriately describe meeting results that affect examination coverage. For more information, see SR-19-5, "Communication Expectations for Community Bank Examinations and Inspections."
- *Summary of Risk Categories and Corresponding Examination Procedures.* The scope memorandum should include a preliminary assessment of the bank's condition and major risk areas that will be evaluated through the examination process. This assessment is largely driven through the risk-tiering and scoping

process described above. The scope memorandum should specifically detail the risk category (high, moderate, or low) of each risk type, and provide a description of the expected examination procedures to complete for that area. In addition, any supplemental and reference modules used should be discussed.

- *Summary of Audit and Internal Control Environment.* A summary of the scope and adequacy of the audit environment should be prepared, which may result in a modification of the examination procedures initially expected to be performed. Activities that receive sufficient coverage by the bank's audit system can be tested through the examination process. Certain examination procedures could be eliminated if a bank's audit and internal control areas are deemed satisfactory.
- *Summary of Loan Review.* On the basis of the preliminary risk assessment, the anticipated loan coverage should be detailed in the scope memorandum. In addition to stating the percentage of commercial and commercial real estate loans to be reviewed, the scope memorandum should identify which specialty loan reference modules of the general loan module are to be completed. The memorandum should specify activities within the general loan module to be reviewed as well as the depth of any specialty reviews.
- *Job Staffing.* The staffing for the examination should be detailed. Particular emphasis should be placed on ensuring that appropriate personnel are assigned to the high-risk areas identified in the bank's risk assessment. The institution's organizational structure and complexity are significant considerations when planning the specific supervisory activities to be conducted. In addition, the scope memo should discuss the examination activities that are expected to be performed on-site at the bank as well as the supervision activities that will be performed off-site.

Banks may need additional time to prepare for an examination, particularly for allocating appropriate bank staff to support heavily reviewed areas. Once the scope memo is finalized, Federal Reserve staff should provide bank management with the contact information of key examination personnel. More specifically, the EIC should provide to bank management a verbal overview of the preliminary scope of review and the size and composition of the examination team, including names, roles and responsibilities, workspace needs, and whether staff members will be working on-site or off-site. The EIC also should inform bank management of the approximate number of trainees that will participate in the on-site examination. The EIC should communicate to bank management any subsequent material changes to the scope of review.

Entry Letter

The entry letter or first day letter identifies the information necessary for the successful execution of the examination procedures. The entry letter should 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, effective use of entry letters depends on 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 readily available to Federal Reserve Bank staff. When needed, the entry letter should include requests for information on specialty activities. The specific items selected for inclusion in the entry letter should meet the following guidelines:

- reflect risk-focused supervision objectives and the examination scope
- facilitate efficiency in the examination process and lessen the burden on financial institutions
- limit, to the extent possible, requests for special management reports
- eliminate items used for audit-type procedures (for example, verifications)
- distinguish between information to be sent to the EIC for off-site examination procedures and information to be held at the institution for on-site procedures
- allow management sufficient lead time to prepare the requested information

To allow bank management sufficient time to gather all requested information, examiners should transmit a first day letter to the bank four to eight weeks prior to the examination start date. In addition, when submitting the first day letter, examiners should specify the as-of date for the data requested and note if updated data should be made available on-site. Examiners also should provide contact information for questions regarding the request list and for technical assistance regarding data transmissions.

Performing Examination Procedures

Overview of Examination Documentation (ED) modules. Interagency ED modules form the basis of the examination procedures to be completed during examinations of state member community and regional banks.[3] The ED modules have been developed and designed to define common objectives for the review of important activities within institutions and to assist in the documentation of examination work. The modules are categorized as primary, supplemental, or reference modules. The primary modules contain procedures to assess capital adequacy, asset quality, management and board oversight, earnings, liquidity, and sensitivity to market risk. The supplemental and reference modules address other subject areas, including procedures for conducting a thorough review of a bank's loan and investment portfolio, a comprehensive assessment of funds-management practices, the adequacy of internal controls, the accuracy of regulatory reporting, other assets and other liabilities and asset and wealth management.

The modules establish a three-tiered approach for the review of a bank's activities: The first tier is the core analysis, the second tier is the expanded review, and the final tier is the impact analysis. The core analysis includes a number of decision factors to be considered collectively, as well as individually, when evaluating the potential risk to the bank. To help the examiner determine whether risks are adequately managed, the core analysis section contains a list of procedures that may be considered for completion. When significant deficiencies or weaknesses are noted in the core analysis review, the examiner may reference the expanded and impact analysis for those decision factors that present the greatest degree of risk for the bank.

Use of ED modules. The use of the modules are tailored to the characteristics of each bank based on its size, complexity, and risk profile. As a result, the extent to which each module should be completed will vary from bank to bank. Federal Reserve examiners complete certain ED module procedures based on the bank's risk category for a particular risk type. The risk-tiering process, which is described above, utilizes both qualitative and financial metrics to identify banks that should be subjected to a higher level of examination testing. Much of this information is gathered through the off-site surveillance process. See the manual section entitled, "Federal Reserve System Bank Surveillance Program," for more information.

The quantitative information obtained through the surveillance process is only one consideration, albeit an important one, in setting the examination scope and determining the appropriate procedures to apply at an individual bank. Qualitative considerations, including but not limited to, the nature of the risk, risk management practices, management responsiveness to prior examination findings, the number and significance of prior matters requiring immediate attention or matters requiring attention, also affect an examiner's scoping decision. Examiners should exercise appropriate supervisory judgment when including or excluding examination procedures to complete during an examination.

3. The Federal Reserve, the Federal Deposit Insurance Corporation, and representatives from the state banking agencies maintain and develop the ED modules.

REQUESTING ADDITIONAL INFORMATION AFTER THE START OF THE EXAMINATION

The EIC should have a process for requesting additional documentation from bank staff that avoids duplicative requests. Suggested methods include (1) requiring examiners to first review information already submitted prior to requesting new information, and (2) centralizing information requests through one designated examiner who must verify whether the information has already been provided.

REPORTING THE FINDINGS: REPORT OF EXAMINATION

Community Bank Report of Examination

The format of the community bank report of examination focuses on content rather than specific pages. The format allows examiners to use certain content headings, which follow a continuous-flow reporting format, and to use certain required report pages. The community bank examination report format may, however, continue to consist of specific or individual report pages, depending on the circumstances.

The community bank report of examination instructions distinguish between mandatory content (when the bank's condition or circumstances warrant) versus optional content. The examiner thus has discretion in the arrangement of certain content. For examinations (and inspections) of community banking organizations rated "4" or "5," examiners may use a letter-format report provided all mandatory and any applicable optional information is in the report.

Subject to certain limitations, the examiner may customize and streamline the community bank examination report to focus the examination's findings on matters of risk and importance to the bank's overall financial condition. The format for the community bank examination report and its instructions should strengthen communications with the bank's board of directors and senior management and minimize reporting burden. The report incorporates applicable specialty examination findings with the overall safety-and-soundness findings, thus culminating in a more comprehensive safety-and-soundness assessment.

The scope and depth of matters discussed under a content heading or on an examination report page, whether required or optional, will vary based on the issues and areas of concern presented as well as on their severity. A more abbreviated discussion may be warranted for community banks that are found to be in sound financial condition, with no material concerns or issues. All examination reports should contain sufficient documentation to support findings and supervisory conclusions.

Examiners completing the community bank examination report also should follow the guidance presented in the Interagency Policy Statement on the Report of Examination. Federal Financial Institutions Examination Council members developed a principles-based approach for completing the report of examination to achieve the objectives of promoting consistency and communication amongst the agencies, while allowing individual supervisors the flexibility to document their assessment of financial institutions of different sizes, activities, risk profiles, and financial and managerial conditions. See SR-19-6, "Interagency Policy Statement on the Report of Examination," for more information.

The instructions below list the content headings or report pages of the open and confidential sections of the community bank examination report. The sequence of applicable pages through the Management/Risk Management section are static. The remaining pages should generally follow the sequence of pages outlined in the template. The financial components (CAELS) may be arranged in order of importance and the corresponding ratios/tables associated with each financial component should be adjusted to illustrate the specific circumstances at the institution.

COMMUNITY BANK REPORT OF EXAMINATION INSTRUCTIONS

Open Section[4]

Content Heading or Report Page Title

Cover Page

A separate cover page is *mandatory*. The cover sheet should contain a statement that the contents of the report of examination contain confidential supervisory information.

Table of Contents

A separate table of contents page is *mandatory*. The table of contents indicates the pages included in the report. All mandatory pages are to be included in each examination report. Optional pages are added as necessary. The mandatory Signature of Directors page is the last page in the open section of the report. Additional supplemental pages may be added to the report at the examiner's discretion. Page numbers should be included for completeness.

Scope

The Scope content heading or report page is *mandatory*. This page may be a combined content heading or a separate report page. The scope should include the examiner's comments on examination depth, scope, and procedures per-

4. An illustrative template of the community bank report of examination is provided at the end of this manual section. The asterisk (*) next to a report page denotes an optional page that is mandatory if circumstances relevant to the page apply.

formed for each area of review, including any specialty areas. The examination's scope should generally address the following:

- the date of examination (commencement and conclusion)
- the type of examination (full-scope, targeted, joint, concurrent, combined (bank and bank holding company))
- the agency or agencies conducting the community bank examination
- areas reviewed and analyzed (If the examination is targeted, the examiner should identify specific areas reviewed.)
- the percentage and type of loans reviewed, if any
- a confirmation that examination results were discussed with the organization, including a list of those who attended the meeting
- identification of the bank's peer group
- if necessary, recognition that the bank is operating under a formal or informal supervisory action (If so, state that the provisions of the action were reviewed and compliance was assessed.)

Summary of Examination Ratings

The Summary of Examination Ratings content heading or report page is *mandatory.* All supervisory ratings assigned during the examination and for the two previous examinations should be provided. The supervisory ratings should be followed by the uniform definition of the assigned composite rating. The uniform definitions of the component ratings assigned need not be included in reports; they should, however, be made available to the board of directors and management on request. Include any specialty or targeted examination ratings assigned or other assessments, including findings from other on-site supervisory events during the recent Federal Reserve examination cycle. In all cases, a concluding statement should be provided that reminds the directorate of its responsibility to review the entire report of examination. The report should instruct each director to sign the Signature of Directors page.

Examination Conclusions

The Examination Conclusions content heading or report page is *mandatory.* This section of the examination report informs the bank's board of directors of the most significant and most important supervisory issues or concerns identified during the examination as well as the examination's findings and general conclusions.

The board of directors and senior management of an institution that is rated a composite "4" or "5" are to be informed that the bank is a problem institution that warrants special supervisory attention.[5] The board of directors and senior management of banks that are rated composite "3" are to be informed that their condition is not satisfactory, that the bank may be subject to more-than-normal supervision, and that the cited supervisory issues and areas of concerns may cause their bank to be considered a problem institution if the weaknesses are not promptly and adequately addressed. This content heading or report page also should discuss significant weaknesses in 1- or 2-rated institutions, and a brief summary of the bank's condition should be provided.

This section should contain an overview of the bank's financial condition. In addition, this section should contain the examiner's most significant recommendations and management's plans for corrective action.

In terms of presenting the information, examiners should include references to additional supporting information elsewhere in the report. The most important comments should be described first. Comments should be provided primarily on areas of the bank's operations and aspects of its financial condition that display weaknesses, deficiencies, or vulnerabilities. While examiners may recognize positive actions taken by management, laudatory or conclusive remarks and endorsements of specific management actions should be avoided.

Significant recommendations presented elsewhere in the report should be mentioned. Significant apparent violations should also be discussed briefly, but they should be presented in greater detail under the content heading or the report page for Apparent Violations of Laws and Regulations.

5. See the subsection below entitled "Community State Member Banks Rated Composite '4' or '5'," for more information on the use of a letter-format report for communicating the findings of on-site, safety-and-soundness examinations hat result in composite supervisory ratings of "4" or "5."

Apparent Violations of Laws and Regulations

The content heading or report page is optional.* However, when apparent violations of federal or state banking laws and regulations are found, it is *mandatory* that they be listed in detail on this page. Apparent violations of the Bank Secrecy Act should also be listed in detail on the Bank Secrecy Act and Anti-Money-Laundering Compliance report page.

The format for listing apparent violations should be consistent. A heading for each apparent violation listed should name the applicable statute and/or regulation and provide a brief description of what the law covers. This summary should be followed by a brief description of the requirements of the statute and/or regulation and a discussion of how or why the apparent violation occurred. The examiner should describe any plans or recommendations for correction. If a review of the Bank Secrecy Act is conducted separately, or as part of another examination, a statement of this fact should be included under the Bank Secrecy Act and Anti-Money-Laundering Compliance report page.

Matters Requiring Attention

The Matters Requiring Attention content heading or report page is *mandatory*. It is intended to complement the complete findings of the report of examination and is prepared for the use of the board of directors and the bank's management. The focus should be on identified problems, rather than on strengths of the organization. Problems should be presented succinctly and clearly. In all cases, the types of actions to be taken by the directors and management to address these problems should be specifically noted.

Include a brief summary statement regarding the status of prior MRIAs and MRAs. A detailed assessment of each prior MRIA or MRA is not required. For example, verbiage in the section could state that all, most, or none of the required items were addressed. Comments in this section should provide a reference to any section of the report where issues that are repeated or incomplete are discussed, if applicable. Repeated matters requiring attention that were not considered previously addressed should be explained in this section.

The definitions of MRIAs and MRAs should be included as a footnote on this page. When issuing a supervisory finding (including through the issuance of an MRIA or MRA), examiners should not criticize an institution for a "violation" of supervisory guidance (as supervisory guidance is not legally binding). When appropriate, examiners may reference (including in writing) supervisory guidance (such as interagency statements, advisories, bulletins, and policy statements) to provide examples of safe-and-sound conduct, appropriate risk management practices, and other approaches to addressing compliance with laws or regulations.

Compliance with Enforcement Actions

The Compliance with Enforcement Actions content heading or report page is optional.* The heading or page is *mandatory,* however, if the institution is under a formal or informal supervisory action. An assessment that summarizes the institution's overall compliance with the supervisory action should be included in this section of the report. As appropriate, the examiner should describe the level of compliance for each provision; provide detailed analysis explaining how compliance was achieved; or detail what actions have been taken and what actions are necessary to achieve full compliance. A detailed assessment of provisions that have been in full compliance for more than one examination is not required.

Directorate Responsibility

The content heading or report page is *mandatory*. This section, which is located after the presentation of key examination findings, is to inform each member of the board that they are responsible for thoroughly reviewing the report of examination. Each director must sign the Signature of Directors page at the conclusion of this report. This page also includes standard language informing the institution of its right to appeal material supervisory determinations. See 85 *Federal Register* 15,175 (March 17, 2020) for more information on the Federal Reserve's appeals process.

Management/Risk Management

The content heading or report page is *mandatory.* A separate section is required. The reported information under this content heading should always include (1) the risk-management numerical rating; (2) the mandatory discussion of the risk factors—types of risk (discussion of operational risk, legal risk, and compliance risk should be included in this section of the report. Discussion of credit risk, market risk, and liquidity risk, should be included in the Analysis of Financial Factors section for the respective financial component); (3) the adequacy of risk management associated with risk levels and risk trends; and (4) the impact of specialty examination areas on relevant risk areas. The fourth item, for example, might consist of a discussion of the impact of any information technology concerns on operational and other relevant risks, what impact any findings on fiduciary activities have on legal or other risks, or compliance concerns. As applicable, examiners should communicate conclusions/findings of any evaluation of the adequacy of an institution's audit department/program as part of this section. Findings can be communicated as part of the overall Management comments, or as a standalone "Audit" subsection within the Management/Risk Management section.

Within this section of the report, management and the board of directors should be evaluated on how they operate the institution in a safe and sound manner and on their ability to identify, measure, monitor, and control the risks of the institution's activities. Examiners should give consideration to

1. the level, quality, and adequacy of supervisory oversight and support provided by the board of directors and senior management;
2. compliance with banking and other statutes, regulations, and supervisory agreements;
3. the ability to plan for and respond to risks that may arise from changing business conditions or the initiation of a new product or service;
4. the accuracy, timeliness, and effectiveness of management information and risk-monitoring systems used to control risks throughout the bank;
5. the adequacy and level of compliance with the board of directors policies and procedures and the bank's other internal policies and controls that are necessary to operate the bank in a safe and sound manner;
6. the adequacy of internal accounting control systems, the bank's audits and audit function, and the bank's internal control systems (discuss all of these in detail);
7. the responsiveness to recommendations from auditors and supervisory authorities;
8. the reasonableness of compensation policies and avoidance of, or tendency toward, self-dealing;
9. the business strategy and policies and procedures for avoiding conflicts of interests;
10. a demonstrated understanding and willingness to serve the legitimate banking needs of the community;
11. the institution's management depth and succession;
12. the extent that management is affected by or is susceptible to dominant influence or concentration of authority; and
13. the overall risk profile and performance of the institution.

See SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $50 Billion," and this manual's section on "Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System and the Federal Reserve's Risk Management Rating," for specific guidance on rating the adequacy of risk-management processes and internal controls.

Examiners should provide the risk-management rating and discuss the risk factors and the adequacy of risk management associated with the risk levels and risk trends. In addition, examiners should discuss the impact of specialty areas on relevant risk areas. For example, examiners should discuss the impact of any information technology concerns on operational and other relevant risks as well as what impact any findings on fiduciary activities or compliance concerns have on legal and other risks. The section should discuss the management and risk-management analysis and "R" rating assignment for the bank holding company RFI/C(D) rating as well as the examiner's risk management conclusions about the bank holding company.

Risk Assessment Matrix

The inclusion of a risk assessment matrix is *mandatory* under the Management/Risk Management content heading.

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 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 is a basis for preparation of the narrative risk assessment.

Activities and their significance can be identified by reviewing information from the institution, the Reserve Bank, or other supervisors. After the significant activities are identified, the type and level of risk inherent in them should be determined. Types of risk may be categorized as previously described or by using categories defined either by the institution or 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.

For the identified functions 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. 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.

This risk assessment is made without considering management processes and controls. Those factors are considered when evaluating the adequacy of the institution's risk-management systems. When assessing the adequacy of an institution's risk management systems for identified functions or activities, the focus should be on findings related to the 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 examiner 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, which the board understands, reviews, and approves. Policies and limits are supported by risk monitoring procedures, reports, and management information systems that provide the necessary information and analysis 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, poli-

cies 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.

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. To facilitate consistency in the preparation of the risk matrix, general definitions of the composite level of risk for significant activities are provided as follows:
- A *high composite risk* generally would be assigned to an activity in which 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, in some cases, even when 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, which the risk management systems appropriately mitigate. For an activity with 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 when internal controls and risk management systems are strong, and when they effectively mitigate much of the risk.

While support comments for operational, legal, and compliance risks will be included in Risk Assessment Matrix section of the report of examination, supporting comments for credit, market, and liquidity risks, can be found under their respective components in the Analysis of Financial Factors section.
- *Operational Risk* is the risk resulting from inadequate or failed internal processes, people, and systems or from external events (this definition is consistent with the Basel committee's definition of operational risk).
- *Compliance Risk* is the risk of regulatory sanctions, fines, penalties, or losses resulting from failure to comply with laws, rules, regulations, or other supervisory requirements applicable to a financial institution.
- *Legal Risk* is the potential that actions against he institution that result in unenforceable contracts, lawsuits, legal sanctions, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a financial institution.

The following is an example of the Risk Assessment Matrix:

Risk Assessment Matrix

Type of risk	*Inherent risk*	*Adequacy of risk management*	*Composite risk*	*Trend*
Credit	Moderate	Weak	High	Increasing
Market	Low	Weak	Low	Stable
Liquidity	High	Strong	Moderate	Decreasing
Operational	Low	Acceptable	Low	Stable
Legal	Low	Acceptable	Low	Stable
Compliance	Low	Acceptable	Low	Stable

Analysis of Financial Factors

The content heading or report page is *mandatory.* It is to be included as a separate section and should include all analyses and conclusions for each financial component. Subheadings are to be used to depict the ratings and the analysis of the individual components and other topics of discussion. The order is optional. However, the more significant issues should be addressed at the beginning of this analysis. In addition to the CAELS components—Capital adequacy, Asset quality, Earnings, Liquidity, and Sensitivity to market risk—listed below, the bank holding company RFI/C(D) rating system component analysis should be reported in this section, if applicable. Financial tables and graphs are optional. They may also be included in an appendix.

1. *Capital adequacy.* Capital adequacy should be evaluated in relation to relevant regulations, the nature and extent of risks to the bank, and the ability of management to address and control these risks to the organization. Consideration is to be given to (1) the level of, quality of, and changes in capital and the bank's overall financial condition; (2) the nature, trend, and volume of problem assets and the adequacy of the allowance for loan losses, allowance for credit losses and other valuation reserves; (3) risk exposures, including those presented by off-balance-sheet activities; (4) the quality and strength of earnings; (5) the balance sheet's composition, including the nature and amount of intangible assets, market risk, concentration risk, and non-traditional-activity risk; (6) equity maintenance and any growth experiences, plans, and prospects; (7) the reasonableness of dividends; (8) the access to capital markets and other appropriate sources of financial assistance; and (9) the ability of management to address emerging needs for additional capital.
2. *Asset quality*. Asset quality should be evaluated in relation to (1) the level, distribution, severity, and trend of problem, classified, delinquent, nonaccrual, nonperforming, and restructured assets, both on- and off-balance-sheet; (2) the adequacy of the allowance for loan and lease losses, allowance for credit losses and other valuation reserves (including the adequacy of the bank's methodology and written documentation policies, procedures, and practices); (3) management's awareness of problem loans and their causes and its demonstrated ability to identify, administer, and collect problem assets; (4) the diversification and quality of loan and investment portfolios; (5) the adequacy of loan-administration and lending policies, procedures, and practices; (6) the adequacy of workout procedures for problem credits; (7) the quality of investment securities and the adequacy of investment policies, procedures, and practices; (8) the extent of securities underwriting activities and exposure to

counterparties in trading activities; (9) the credit risk that is arising from, or reduced by, off-balance-sheet transactions;[6] (10) asset concentrations (including those assets, problem credits, and other transfer-risk problems in particular economic sectors); (11) the volume and nature of documentation exceptions; (12) the effectiveness of credit administration procedures, underwriting standards, risk-identification practices, internal controls, internal loan-review and credit-grading systems (including noted significant differences between the internal loan grades and the examination's loan classifications), and management information systems; and (13) the adequacy of policies, procedures, and practices involving financial futures and foreign exchange trading.

3. *Earnings.* The quality and quantity of earnings should be evaluated in relation to (1) the ability to provide for adequate capital through retained earnings; (2) the level, quality (including the strength of net interest margin, the amount of noninterest income and expense, and the extent of reliance on unusual or nonrecurring gains or losses), and stability of earnings; (3) the level of, composition of, reasonableness of assumptions for, and the extent of management's control over any variances between actual results versus the budgeted projections of income and expenses in relation to the size and nature of the bank's operations; (4) the vulnerability of earnings to market-risk exposures; (5) the adequacy of provisions to the allowance for loan and lease losses, allowance for credit losses and other valuation reserves; (6) the impact of extraordinary items, securities transactions, and tax effects on net income; and (7) the adequacy of budgeting systems, forecasting processes (including the reasonableness of assumptions), and management information systems.
4. *Liquidity.*[7] Liquidity and asset-liability management should be evaluated in relation to (1) the trend and stability of deposits; (2) the degree of and reliance on short-term volatile sources of funds, including any undue reliance on borrowings or brokered deposits to fund longer-term assets; (3) the availability of assets that are readily convertible to cash without undue loss; (4) the bank's ability to securitize and sell certain pools of assets; (5) the extent and ease of the bank's access to money markets and other sources of funding; (6) the adequacy of and ease of access to liquidity sources and the bank's ability to meet liquidity needs; (7) the level of securities pledged against liabilities; (8) the bank's ability to obtain borrowed funds from outside sources that are consistent with the bank's funding strategies; (9) the effectiveness of and the extent of compliance with the bank's policies and procedures for funding and managing liquidity, interest-rate risk, management information systems, and contingency funding plans; (10) the capability of management to properly identify, measure, monitor, and control liquidity; (11) the level of diversification of funding sources, both on- and off-balance sheet; (12) the extent of the bank's asset-liability and gap-management practices; and (13) the vulnerability of the bank's funding to adverse publicity, increased reputation risk, and lowered credit ratings.
5. *Sensitivity to market risk.*[8] Sensitivity to market risk reflects (1) the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect earnings or the economic value of capital; (2) the ability of management to identify, measure, monitor, and control exposures to market risk, given the bank's size, complexity, and risk profile; (3) the nature and complexity of interest-rate risk exposure arising from nontrading positions; and (4) where appropriate, the nature and complexity of interest-rate risk arising from trading and foreign operations.

Information Technology Assessment

The inclusion of an information technology (URSIT) assessment as a content heading or report page is optional.* An information tech-

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

7. Liquidity risk is the potential that a financial 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 (referred to as "market liquidity risk").

8. Market risk is the risk to a financial institution's condition resulting from adverse movements in market rates or prices, including, but not limited to, interest rates, foreign exchange rates, commodity prices, or equity prices.

nology assessment is *mandatory*, however, if an URSIT rating is assigned or if significant supervisory concerns exist.[9] Information technology activities should be evaluated based on the nature and extent of information technology risks, including management processes, architecture, integrity, security, and availability. The supporting rationale for composite or component IT ratings should be included. Examiners should note whether a list of technical exceptions was provided to management. It may be appropriate to include descriptions of electronic banking activities. The examiner's conclusions should also be reflected in the Analysis of Financial Factors or the Management/Risk Management sections of the report, as appropriate. Any significant supervisory concerns should be reflected in the Matters Requiring Attention and in the Examination Conclusions sections.

Bank Secrecy and Anti-Money-Laundering Compliance

The content heading or report page is optional.* The section is *mandatory* if Bank Secrecy and Anti-Money-Laundering Compliance is assessed and a conclusion is rendered, or if significant supervisory concerns exist. BSA/AML compliance should be evaluated based upon the nature and extent of risk and non-compliance. Note whether a list of apparent violations or exceptions was provided to management. Conclusions should also be reflected in Analysis of Financial Factors and/or the Management/Risk Management sections of the report, as appropriate, and any significant supervisory concerns should be reflected in the Matters Requiring Attention and Examination Conclusions sections.

Fiduciary Activities Assessment

The content heading or report page is optional.* The heading or page is *mandatory*, however, if a trust (UITRS) or transfer-agent rating was assigned during the most recent Federal Reserve examination cycle or if significant supervisory concerns exist in these areas.[10] Fiduciary activities should be evaluated relative to management's oversight of fiduciary activities and the nature and extent of risk that the fiduciary activities or business lines evaluated present to the institution. Management's ability to assess the risk of fiduciary products and services offered, including new products, should be evaluated. Note whether a list of technical exceptions was provided to management. The supporting rationale for any ratings assigned should be included. Conclusions should also be reflected in the Analysis of Financial Factors or the Management/Risk Management sections of the report, as appropriate. Significant supervisory concerns should be reflected in the Matters Requiring Attention and Examination Conclusions sections.

Items Subject to Adverse Classification

The content heading or report page (and the associated content) is *mandatory*. The topic, however, must be discussed in the examination report. The Summary of Items Subject to Adverse Classification content heading or report page summarizes items classified by the examiner as either substandard, doubtful, or loss as of the examination date (for this page, considered the date relevant to the asset-quality review).[11]

- A *Substandard* asset is inadequately protected by the current sound worth and paying capacity of the obligor or by the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.
- An asset classified *Doubtful* has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.
- Assets classified *Loss* are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery

9. See SR-99-8, "Uniform Rating System for Information Technology," and 64 Fed. Reg. 3,109 (January 20, 1999) for more information.

10. See SR-98-37, "Uniform Interagency Trust Rating System," and 63 Fed. Reg. 54,704 (October 13, 1998) for more information.

11. See SR-13-18, "Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions."

may be effected in the future. Amounts classified *Loss* should be promptly charged off.

Total classifications also are presented for the previous examination. Reserve Banks that are engaged in alternate-year examination programs should provide totals contained in the previous examination report prepared by the state when applicable. The examiner also should consider creating a schedule under the Asset Quality content heading or page to detail classifications from additional prior examinations if meaningful trend information is noted. The examiner should also present, in the report narrative, classification trends for certain asset categories if the analysis is meaningful.

For the examinations of banks engaged in international lending, examiners should provide additional information to include categories for other credit-risk problems and value-impaired assets. Adjustments are required to be made for U.S. addressees and non-U.S. addressees.

For banks with foreign activity, the distinction between U.S. and non-U.S. addressees follows the definition set forth in the Call Report instructions: whether a customer is U.S. or non-U.S. is determined by the customer's principal address, that is, by its domicile. A U.S. address would be in the 50 states of the United States, the District of Columbia, Puerto Rico, or U.S. territories and possessions. Non-U.S. addressees include all other geographical areas.

The examiner should list in the appropriate category the amounts of all credits classified due to transfer risk. The value of credits shown as value impaired should be computed after deducting any allocated transfer-risk reserve that is established against an asset. In determining total classified assets, examiners should arrive at net assets classified due to country risk. Examiners should identify any credits classified due to transfer risk that have received the same or a more severe classification due to credit risk and that are listed above in the summary of classified items due to credit risk. The sum of such assets should be listed in the appropriate column and then deducted to arrive at net assets classified due to country risk. For the purpose of this content heading or report page, any credits classified as value impaired for transfer-risk purposes should not be included in the summary of credits classified due to credit risk, unless the credits are classified loss.

For the purpose of arriving at total classified assets, add the amount classified due to credit risk to net assets classified due to transfer risk for each category. When computing weighted classifications, the residual portion of any value-impaired assets should be assigned the same weight as substandard classifications. However, the residual exposure still remains value impaired for examination and classification purposes. Value-impaired assets held in the trading account should also be included in total classified assets but should not be considered classified assets when computing weighted classifications.

This report page also includes "Specific Items Subject to Adverse Classification." A full loan write-up is mandatory for all significant or material classified assets if (1) management disagrees with the disposition accorded by the examiner or (2) the institution will be rated composite "3," "4," or "5."[12]

Items Listed as Special Mention

The content heading or report page (and the associated content) is *mandatory*. The topic must be discussed in the examination report. The Summary of Items Listed for Special Mention content heading or report page presents the total of assets listed for special mention for the current and one previous examination. A special-mention asset is defined as follows:

A *Special Mention* asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special-mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant classification.[13]

The summary does not include assets listed for special mention when computing classification ratios. Reserve Banks that are engaged in alternate-year examination programs should rely on the special-mention total from the previous state's examination when applicable.

This report page also includes Specific Items Listed for Special Mention. A full loan write-up

12. SR-99-24, "Loan Write-Up Standards for Assets Criticized During Examinations."

13. See SR-93-30, "Interagency Policy Statements on Supervisory Initiatives Released Today." In particular, see the statement entitled, "Interagency Statement on the Supervisory Definition of Special Mention Assets."

is mandatory for all significant or material criticized assets if (1) management disagrees with the disposition accorded by the examiner or (2) the institution will be rated composite “3,” “4,” or “5.”

Assets with Credit-Data or Collateral-Documentation Exceptions

The content heading or report page is optional.* The content heading is *mandatory* if examiners’ ability to assess the loan files or overall asset quality at the bank is compromised because of inadequate information needed for loan line sheets or if the bank’s loan administration systems and processes are deficient, particularly with respect to loan and collateral documentation and collateral values. If the credit data or collateral documentation exceptions are materially significant, this content heading or report page should provide support for a discussion of credit documentation practices under the Asset Quality content heading or report page.

Concentrations

The content heading or report page (and its associated content) is optional.* This page is *mandatory* if there are materially deficient practices in managing concentrations. If included, the content heading should include a discussion of the appropriateness of risk management practices regarding any materially significant concentrations of assets, liabilities, specific industries, and other categories, as applicable. This discussion should address the effectiveness of the bank’s internal policies, systems, and controls to identify, monitor, and manage the risk associated with the concentrations and address the bank’s alternatives or plans for reducing concentrations. Examination staff should comment on their ability to leverage the bank’s internal concentration reporting when conducting the review and assessment of concentrations.

The content heading or report page should indicate that a concentration includes obligations, direct or indirect, of the same or affiliated interests that represent 25 percent or more of the bank’s capital structure. The reader should also be informed that, for the purposes of this page, the capital structure is defined as tier 1 capital plus the allowance. See also SR-20-8, “Joint Statement on Adjustment to the Calculation for Credit Concentration Ratios Used in the Supervisory Approach” and this manual’s section entitled, “Concentrations of Credit.”

When determining and calculating concentrations, the amount of loan commitments and other off-balance-sheet risk items should be considered. The listing should include all types of loans, overdrafts, cash items, suspense resources, securities, leases, acceptances, advances, letters of credit, and all other items due to the bank as well as loans endorsed, guaranteed, or cosigned by related individuals and their related interests.

Concentrations by industry, transfer risk, product line, type of collateral, and other characteristics should be detailed when appropriate. The listing should include amounts due from depository institutions, federal funds sold, and other assets in which payment depends on one financial institution or affiliated group and the total represents 25 percent or more of the bank’s capital structure. Treasury securities, obligations of U.S. government agencies and corporations, and any assets collateralized by these items should not be included in the listing. The requirements of Regulation F (12 CFR 206), as they relate to concentrations involving correspondent banks, should also be considered.

Capital Calculations

The Capital Calculations page is optional.* Inclusion of capital calculations is mandatory, however, if (1) the bank has a financial subsidiary within the meaning of the Gramm-Leach-Bliley Act, (2) there is a change in the capital category as a result of the examination, or (3) the ratios supporting the capital category in the examination are not derived from the bank’s Call Report as of the same date. The third exception could occur if the bank’s examination ratios were calculated at a date other than the end of a quarter, or, if calculated at quarter-end, the numbers were adjusted or changed from those filed in the Call Report. It should be noted tier 2 capital and risk-weighted calculations are not required for banks that have opted in to the community bank leverage ratio framework.

Other Matters

This content heading or report page is optional.* If included, discuss issues or other matters of significance not covered elsewhere in the community bank's examination report. Discuss also significant matters mentioned elsewhere that require further explanation, such as the type, scope, and volume of any new activity in which the bank is engaged. If issues or concerns are noted, examiners should provide comments on specific areas, such as the following:

- accounting and internal controls
- affiliate relationships
- criminal referral procedures
- emergency preparedness
- financial recordkeeping and reporting regulations
- insurance
- investment in bank premises
- litigation
- security and controls against external crimes
- payments system risk
- nontraditional banking activities (for example, mortgage warehousing or data processing services)
- supervisory reporting
- nondeposit investment products

Other examination matters also may warrant comments on this report page.

Signature of Directors

The content heading is *mandatory*. A separate report page is required and should be the last page in the open section of the report.

Confidential Section

The "Confidential Section" is *mandatory*. This section of the bank examination report is mandatory. It must include all information that cannot or should not be disclosed or made available to the bank. It should also include internal administrative and supervisory information relevant to the Federal Reserve System and its staff. The order of the following headings or pages is at the examiner's discretion.

Directors and Officers

The content heading or report page is *mandatory* for inclusion in the report. A separate report page is required. All bank directors should be listed in alphabetical order. If the bank elects advisory directors, they should be listed alphabetically under a separate heading. Information requested in the report page header should be supplied for each director. Specific instructions for certain requested information are as follows:

- Under meetings missed, include all meetings a director has not attended between the previous (Reserve Bank or state) and current examination. If a director was elected since the previous examination, list only the number of meetings that they missed since the date of election.
- Under fees paid to each director, indicate whether the compensation is based on attendance.
- Under occupation or principal business affiliation, use concise and descriptive designations (for example, farmer, grocer, or commercial real estate developer).

For banks with active board committees, a code or legend for all committees should be prepared, indicating committee memberships for each director. The Executive Officers portion of the report page uses the Regulation O (12 CFR 215) definition of executive officers, but other significant officers may be included at the examiner's discretion. Information requested by the report page should be supplied. Additional individuals to be reported may include persons without official designation who exercise considerable influence or executive officers excluded from the Regulation O definition by board resolution who actually maintain a high level of responsibility. Officers should be listed in order of title or position of responsibility, with dominant individuals shown first.

Specific instructions for the requested information for the report page are as follows:

- Examples of assigned areas of responsibility may include administration, policy formulation, lending, operations, or branch manager.
- A salary should indicate the current annual salary. The total bonuses should be reported for the previous year.

If executive officers receive any other pertinent forms of compensation beyond their listed salary and bonus (such as commission-based pay, employment contracts, stock options, unusually large benefits, or affiliated bank salaries and fees), these should be discussed in narrative format below the listing of executive officers or on a separate page.

General Information

The content heading is *mandatory*. It includes (1) a discussion of strategic plans, future technology plans, planned bank products or services, or prospects for the bank; (2) significant or sensitive matters regarding the bank's management not previously addressed; (3) applicable comments on the extent that a particular insider controls or dominates the organization and any adverse effect of insiders on operating policies, procedures, or the overall financial condition of the bank; and (4) a discussion of any recommendations for supervisory actions and any additional material matters of a sensitive or confidential nature not previously addressed. To the extent not included on the Directors and Officers page, this discussion should also include a list of each of the major shareholders of the bank (those having 5 percent or more ownership) and their respective percentage of ownership. When the major shareholder is a bank holding company, its major shareholders and the percent controlled by each shareholder also should be listed. A listing of critical turnkey software vendors or information technology service providers as well as any client institutions for which processing services are provided should be included. Include any significant matters of a confidential nature regarding vendors or third-party service providers. Also include a description of any electronic banking activities.

COMMUNITY STATE MEMBER BANKS RATED COMPOSITE "4" OR "5"

The Federal Reserve has adopted a flexible, letter-format report in lieu of the standard, longer-form report for communicating the findings of on-site, safety-and-soundness examinations and inspections of community banking organizations that result in composite supervisory ratings of "4" or "5." Examiners may use a letter-format report for examination and inspections of community banking organizations rated "4" or "5," provided all mandatory and any applicable optional information is in the report.

The option of using a flexible letter-format for such community banking organizations will enable Reserve Banks to focus their reports on key findings and improve the communication of supervisory expectations to companies in need of significant improvement. In addition, given the increased examination frequency of community banking organizations with a "4" or "5" rating (typically every six months), the letter format will also hasten the communication of supervisory expectations.

Examiners are to follow the examination report guidance provided above for full-scope examinations of community banking organizations rated "1," "2," or "3."[14] That guidance provides for some flexibility in the structuring of the examination reports, so long as all mandatory and applicable optional content is covered. Examiners have flexibility in writing the narrative portion of reports.

Content of the Letter Format of Examination

A letter format report of examination for SMBs rated "4" or "5" should be tailored to fit the particular circumstances of the institution under review and should fully address the key areas that are routinely covered in the mandatory pages of the open and confidential sections of the standard report of examination.

These areas in the open section of the examination report include

- scope of the examination,
- summary of examination ratings,
- matters requiring attention,
- conclusions regarding management and risk management (addressing risk factors and the adequacy of risk management associated with risk levels and trends, which includes a risk-assessment matrix),
- analysis of financial factors,
- summary of items subject to classification or listed as special mention,
- signature of directors, and
- any applicable areas that are described as optional pages in the standard report of examination instructions and are necessary to support examiners' findings. Examples of these areas include compliance with enforcement actions and apparent violations of laws or regulations.

14. The flexible letter format may also be used on target examinations of 3-rated community banking organizations, as applicable.

These areas in the confidential section of the examination report include

- directors and officers, which includes information such as duties, length of service, and committee assignments; and
- general information about the institution, including sensitive matters not addressed in the open section of the report such as strategic and information technology plans, planned new products and services, insider influence, and recommended supervisory actions.

Communication of Supervisory Findings

As with standard reports of examination and inspection, the letter-format reports must notify a banking organization and its board of the organization's supervisory rating and the confidential nature of the letter. The letter-format report should also set forth the deadline by which the organization must reply to the Federal Reserve Bank, including the organization's plans to address any matters requiring immediate attention or matters requiring attention that are noted in the report. For more information, see this manual's section entitled, "Examination Strategy and Risk-Focused Examinations."

COMPLETION STANDARD FOR EXAMINATION AND INSPECTION REPORTS

Community Banks

Safety-and-soundness examination and inspection reports for community banking organizations issued by the Federal Reserve should be completed and sent to the supervised institution within a maximum of 60 calendar days following the "close date" of the examination. These standards apply to formal examination and inspection reports for institutions supervised by the Federal Reserve with $10 billion or less in total consolidated assets, including SMBs, bank holding companies, savings and loan holding companies, Edge Act and agreement corporations, U.S. branches and agencies of foreign banks, and foreign subsidiaries and branches of U.S. banks.[15] For institutions rated composite "3," "4," or "5," Reserve Banks are encouraged to adopt an internal target of 45 calendar days from the close date for sending the reports.

The "close date" of an on-site examination and inspection is defined as the last date that the examination team is physically on-site at the institution. For examinations and inspections for which all or a portion of the work is performed off-site, the "close date" is defined as the earlier of the following dates: (1) the date when the analysis (including loan file review) is completed and ready for the EIC's review or (2) the date when the preliminary exit meeting is held with management, which can be conducted either on-site or off-site by conference call.

Further, to ensure that findings are communicated to a supervised institution in a timely manner, Reserve Banks should ensure that the duration between the start of an examination/inspection to the completion and delivery of an examination/inspection report does not exceed 90 days.[16] In cases when reports are subject to statutory requirements for other state or federal agency review, such as by the Consumer Financial Protection Bureau (CFPB),[17] Reserve Banks may exceed the guidelines included in SR-13-14, "Timing Standards for the Completion of Safety-and-Soundness Examination and Inspection Reports for Community Banking Organizations," at the discretion of senior management. However, deviations from these guidelines are expected to be rare. At the discretion of senior Reserve Bank management, additional exemptions from this 90-day guideline may be considered for examinations that are conducted simultaneously on multiple affiliated banks or examinations of larger complex community banking organizations that require additional time on-site to review specialized or complex business lines.

15. Bank and savings and loan holding companies with total consolidated assets of $3 billion or less are subject to a separate program that has different requirements for the issuance of reports of inspection. See SR-13-21, "Inspection Frequency and Scope Requirements for Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of $10 Billion or Less."

16. The start date is the date that Reserve Bank examiners and supervisory staff commence the examination and inspection work, excluding pre-examination visitations and preparation.

17. See sections 1022, 1024, and 1025 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. For more information on the coordination of supervisory activities with the CFPB, see also the "Memorandum of Understanding on Supervisory Coordination" and the June 4, 2012, press release.

In addition, findings and conclusions delivered to a supervised institution at the close date and exit meetings for examinations and inspections must be consistently documented in work papers.[18] At a minimum, documentation should include:

1. a list of attendees at the meetings;
2. a description of significant examination and inspection findings discussed, including preliminary ratings; and
3. a summary of the bank management's views on the findings and, if applicable, the views of the board of directors.

18. In some cases, Reserve Bank examiners or supervisory staff may conduct a pre-exit meeting with the institution's management at the close date of the examination or inspection. Representatives from the on-site examination or inspection team may also hold a final exit meeting with the institution after vetting examination or inspection findings with the responsible Reserve Bank officer(s). An "exit meeting" is defined as an examiner's meeting with the institution's management or management and board of directors to communicate preliminary supervisory findings and conclusions.

To the extent conclusions in the final report differ from those discussed at the close date and exit meetings, Reserve Bank examiners and supervisory staff should communicate the reasons for the differences to the supervised institution and document these discussions in their work papers. (See SR-13-14.)

COMMUNITY BANK REPORT OF EXAMINATION ILLUSTRATIVE TEMPLATE

The following pages provide an illustrative template of the community bank report of examination. Detailed descriptions of the report of examination pages are provided above in the subsection entitled, "Community Bank Report of Examination Instructions." The following template also contains clarifying instructions to examination staff, which are noted by the italicized text.

COMMUNITY BANK
REPORT OF EXAMINATION

Restricted FR

Name: ______________________________ Financial statement date: ________________

Location: ____________________________ Start date: ____________________________

RSSD ID number: ______________________

THIS REPORT OF EXAMINATION IS STRICTLY CONFIDENTIAL

This document has been prepared by an examiner selected or approved by the Board of Governors of the Federal Reserve System. The document is the property of the Board of Governors and is furnished to directors and management for their confidential use. The document is strictly privileged and confidential under applicable law, and the Board of Governors has forbidden its disclosure in any manner without its permission, except in limited circumstances specified in the law (12 U.S.C. 1817(a) and 1831m) and in the regulations of the Board of Governors (12 CFR 261.20).

Under no circumstances should the directors, officers, employees, trustees or independent auditors disclose or make public this document or any portion thereof except in accordance with applicable law and the regulations of the Board of Governors.

Any unauthorized disclosure of the document may subject the person or persons disclosing or receiving such information to the penalties of section 641 of the U.S. Criminal Code (18 U.S.C. 641).

Each director or trustee, in keeping with his or her responsibilities, should become fully informed regarding the contents of this document. In making this review, it should be noted that this document is not an audit, and should not be considered as such.

FEDERAL RESERVE BANK OF [*Insert name of bank*]

REPORT OF COMMERCIAL BANK EXAMINATION

Name of bank Street City

County State Zip code

Mailing address

___ Joint ___ Concurrent ___ Independent

Federal Reserve Bank Examiner-in-Charge ________________

Federal Reserve Bank Nominee Examiner-in-Charge ________________

(FOR JOINT EXAMS ONLY) Participating Agency Examiner-in-Charge ________________

TABLE OF CONTENTS

Note: Except as indicated, amounts in tables are shown to the nearest thousand dollars.

Scope

Summary of Examination Ratings[1]

Uniform Financial Institution Rating System	Current exam	Prior Exam	Prior exam
Start Date			
Regulatory Agency			
Financial Statement Date			
Composite Rating			
Component Ratings			
Capital			
Asset Quality			
Management			
Earnings			
Liquidity			
Sensitivity to Market Risk			
Risk Management			
Uniform Rating System for Information Technology			
Information Technology Composite Rating			
Information Technology Component Ratings			
Audit			
Management			
Development and Acquisition			
Support and Delivery			

1. Detailed definitions of examination ratings can be found in the *Commercial Bank Examination Manual* and 61 Fed. Reg. 67,021 (December 19, 1996).

	Current Exam	Prior Exam	Prior Exam
Uniform Interagency Trust Rating System			
Trust Composite Rating	________	________	________
Managment	________	________	________
Operations, Internal Controls, and Auditing	________	________	________
Earnings	________	________	________
Compliance	________	________	________
Asset Management	________	________	________
Other Composite Ratings	Date	Rating	
Consumer Compliance	________	________	
Community Reinvestment Act	________	________	

Composite Rating Definition

Examination Conclusions

Apparent Violations of Laws and Regulations

Matters Requiring Attention[2]

Template Instruction: Include material issues that require the attention of the institution's board and/or senior management in order of importance. Include a brief summary statement regarding the status of prior examination Matters Requiring Attention. Status should communicate if all, most, none, etc. of the required items were addressed. Detailed assessment of each of the prior Matters Requiring Attention is not required. An example of text could include, "All previous Reserve Bank findings are considered to be satisfactorily addressed, unless otherwise noted in this Report of Examination." The comment should, however, provide a reference to any section of the report where issues that are repeated or incomplete are discussed, if applicable. Repeat Matters Requiring Attention, that were not previously considered addressed, should be noted as such in the details of this section.

Directorate Responsibilities

Each member of the board is responsible for thoroughly reviewing this Report of Examination. Each director must sign the Signatures of Directors page at the conclusion of this report, which affirms that he or she has reviewed the Report in its entirety.

Appeals of Material Supervisory Determinations

Any institution about which the Federal Reserve makes a written material supervisory determination is eligible to utilize the appeals process as described in the "Process for Appeals of Material Supervisory Determinations." An appeal under this process may be made of any written material supervisory determination, as defined in the Process for Appeals of Material Supervisory Determinations.[3]

The Board's Ombudsman (Ombudsman) can provide assistance regarding questions related to the System's material supervisory determination appeals process. The Ombudsman can also provide assistance to facilitate the informal resolution of concerns prior to the filing of a formal appeal. An institution may contact the Ombudsman at any time by calling 1-800-337-0429, by sending a facsimile to 202-530-6208, by writing to the Office of the Ombudsman, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, or by sending an email to ombudsman@frb.gov.[4]

EIC Name Examiner-in-Charge Federal Reserve Bank of	(if applicable) (if applicable)

2. Supervisory follow-up may consist of Matters Requiring Immediate Attention (MRIAs) and Matters Requiring Attention (MRAs). MRIAs arising from an examination, inspection, or any other supervisory activity are matters of significant importance and urgency that the Federal Reserve requires banking organizations to address immediately and include (1) matters that have the potential to pose significant risk to the safety and soundness of the banking organization; (2) matters that represent significant noncompliance with applicable laws or regulations; and (3) repeat criticisms that have escalated in importance due to insufficient attention or inaction by the banking organization. MRAs constitute matters that are important and must be addressed to ensure safe, sound and compliant operation, but the threat is less immediate and, therefore, may be addressed over a reasonable and specified period of time. Thus, the key distinction between MRIAs and MRAs is the nature and severity of matters requiring corrective action, as well as the immediacy with which the banking organization must begin and complete corrective actions. MRIAs and MRAs will remain open until resolution and examiners confirm the banking organization's corrective actions.
When issuing a supervisory finding (including through the issuance of an MRIA or MRA), examiners will not criticize an institution for a "violation" of supervisory guidance (as supervisory guidance is not legally binding). When appropriate, examiners may reference (including in writing) supervisory guidance to provide examples of safe-and-sound conduct, appropriate risk-management practices, and other approaches to addressing compliance with applicable statutes or regulations. See SR-18-5/CA-18-7, "Interagency Statement Clarifying the Role of Supervisory Guidance."
3. 85 Fed. Reg. 15,175 (March 17, 2020).
4. See also the Ombudsman Policy Statement on the Board's website.

Compliance with Enforcement Actions

Template Instruction: The Compliance with Enforcement Actions content heading or report page is optional. The heading or page is mandatory, however, if the institution is under a formal or informal supervisory action. An assessment that summarizes the institution's overall compliance with the action should be included in this section of the report. The examiner should include the level of compliance for each provision and provide detailed analysis that includes how compliance was achieved or detail what actions have been taken and what actions are necessary to achieve full compliance, as appropriate. A detailed assessment of provisions that have been in full compliance for more than one examination is not required.

Management/Risk Management

Template Instruction: Provide the risk management numerical rating and discussion of risk factors and the adequacy of risk management associated with risk levels and risk trends. The impact of specialty examination areas on relevant risk areas should be incorporated. For example, the impact of any information technology concerns on operational and other relevant risks should be discussed as well as the impact on legal or other risks of any findings with respect to fiduciary activities or compliance concerns. As applicable, examiners should communicate conclusions/findings of any evaluation of the adequacy of an institution's audit department/program as part of this section. Findings can be communicated as part of the overall Management comments, or as a standalone "Audit" subsection within the Management/Risk Management section.

Management/Risk Management[5] - [Insert management rating]/[Insert risk management rating]

(Comment is mandatory)

Template Instruction: A risk assessment matrix shall be included.

Risk Assessment Matrix

Risk type	Inherent risk	Adequacy of risk management	Composite risk	Trend
Overall	______	______	______	______
Credit	______	______	______	______
Market	______	______	______	______
Liquidity	______	______	______	______
Operational	______	______	______	______
Legal	______	______	______	______
Compliance	______	______	______	______

Operational Risk *(Comment is mandatory)*

Legal and Compliance Risks *(Comment is mandatory)*

5. Supporting comments for credit, market, and liquidity risks, if not discussed in this section, may be found under their respective components in the Analysis of Financial Factors section.

Analysis of Financial Factors

Template Instruction: Include analysis and conclusions for each financial component in this section using subheadings to depict ratings and analysis of individual components and other topics of discussion. The order is optional; however, the more significant issues should be addressed up front. Narrative comments and support should generally be brief for 1- and 2-rated components and increase in detail and specificity for 3-, 4-, and 5-rated components.

Financial tables below can be customized to match the conclusions, risk, and messages being communicated to institution management. Nonapplicable ratios should be removed or denoted as not applicable with "N/A" in all nonapplicable columns.

Capital Adequacy – [*Insert rating*]

Ratios	Bank *Date*	Peer *Date*	Bank *Date*	Bank *Date*
Tier 1 Leverage Capital[6]	________	________	________	________
Common Equity Tier 1 Capital Ratio[7]	________	________	________	________
Tier 1 Risk-Based Capital/Risk-Weighted Assets[8]	________	________	________	________
Total Risk-Based Capital/Risk-Weighted Assets	________	________	________	________
Cash Dividends/Net Income	________	________	________	________

Capital *(Comment is mandatory)*

6. Tier 1 Capital/Average Total Assets.
7. Common Equity Tier 1 Capital/Total Risk-Weighted Assets.
8. Risk-Weighted Assets used in the above calculations can be found in the institution's Uniform Bank Performance Report, unless otherwise noted.

Asset Quality – [*Insert rating*]

Ratios	Current asset review	Prior asset review *(Date)*	Prior asset review *(Date)*
Total Adversely Classified Assets/ Tier 1 Capital + Allowance[9]	____________	____________	____________
Weighted Adversely Classified Assets[10]/ Tier 1 Capital + Allowance	____________	____________	____________

Ratios	Bank *(Date 1)*	Peer *(Date 1)*	Bank *(Date 2)*	Bank *(Date 3)*
90+ Days Past Due and Nonaccrual Loans and Leases/Loans and Leases	_________	_________	_________	_________
Net Loan Loss/Total Loans	_________	_________	_________	_________
Allowance/Total Loans	_________	_________	_________	_________

Credit risk *(Comment is mandatory)*

9. Allowance refers to allowance for loan and lease losses or allowance for credit losses. For more information on the calculation of the denominator of this ratio, see SR-20-8, "Joint Statement on Adjustment to the Calculation for Credit Concentration Ratios Used in the Supervisory Approach," and the *Commercial Bank Examination Manual.*

10. Weighted Adversely Classified Assets is the summation of each classification category utilizing the following weights: Substandard 20 percent, Doubtful 50 percent, and Loss 100 percent.

Earnings — [*Insert rating*]

Ratios	Bank *(Date)*	Peer *(Date)*	Bank *(Date)*	Bank *(Date)*
Return on Average Assets[11] (Subchapter S)	________	________	________	________
Net Interest Margin[12]	________	________	________	________
Noninterest Income/Average Assets	________	________	________	________
Noninterest Expense/Average Assets	________	________	________	________
Provision Expense/Average Assets	________	________	________	________

(Comment is mandatory)

Liquidity – [*Insert rating*]

Ratios	Bank *(Date)*	Peer *(Date)*	Bank *(Date)*	Bank *(Date)*
Net Noncore Funding Dependence[13]	________	________	________	________
Core Deposits/Assets	________	________	________	________
Net Loans and Leases/Deposits	________	________	________	________
Liquid Assets/Total Assets	________	________	________	________

Liquidity Risk *(Comment is mandatory)*

11. Net Income/Average Assets ratio may be adjusted for Subchapter S status, if applicable.
12. Net Interest Income/Average Earning Assets.
13. (Noncore Liabilities *less* Short Term Investments)/Long Term Assets.

Sensitivity to Market Risk — [*Insert rating*]

	Model Results as of mm/dd/yyyy						
Market Risk Metrics	-200	-100	Limit	+100	Limit	+200	Limit
Change in EVE %	_______	_______	_______	_______	_______	_______	_______
Change in EVE % (prior year)	_______	_______	_______	_______	_______	_______	_______
Change in EAR %	_______	_______	_______	_______	_______	_______	_______
Change in EAR % (prior year)	_______	_______	_______	_______	_______	_______	_______

Market Risk *(Comment is mandatory)*

Information Technology Assessment

Information Technology – [*Insert rating(s)*]

Template Instruction: Section is mandatory if an information technology (URSIT) rating is assigned or if significant supervisory concerns exist. Information technology activities should be evaluated based upon the nature and extent of information technology risks including management processes, architecture, integrity, security and availability. Supporting rationale for composite and/or component IT ratings should be included. Note whether a list of technical exceptions was provided to management. Conclusions should also be reflected in Analysis of Financial Factors and/or the Management/Risk Management sections of the report, as appropriate, and any significant supervisory concerns should be reflected in the Matters Requiring Attention and Examination Conclusions sections.

Bank Secrecy & Anti-Money-Laundering Compliance

Template Instruction: Section is mandatory if Bank Secrecy Act (BSA) and Anti-Money-Laundering (AML) compliance is assessed and a conclusion is rendered, or if significant supervisory concerns exist. BSA/AML compliance should be evaluated based upon the nature and extent of risk and noncompliance. Supporting rationale for the conclusion should be included. Note whether a list of violations or exceptions was provided to management. Conclusions should also be reflected in Analysis of Financial Factors and/or the Management/Risk Management sections of the report, as appropriate, and any significant supervisory concerns should be reflected in the Matters Requiring Attention and Examination Conclusions sections.

Fiduciary Activities Assessment

Fiduciary Activities Assessment – [*Insert rating(s)*]

Template Instruction: Section is mandatory if a trust (UITRS) or transfer agent rating is assigned during the most recent Federal Reserve examination cycle or if significant supervisory concerns exist in these areas. Fiduciary activities should be evaluated relative to management's oversight of fiduciary activities and the nature and extent of risk to the institution represented by the fiduciary activities or business lines evaluated. Management's ability to assess the risk of fiduciary products and services offered, including new products, should be evaluated. Note whether a list of technical exceptions was provided to management. Supporting rationale for any ratings assigned should be included. Conclusions should also be reflected in Analysis of Financial Factors and/or the Management/Risk Management sections of the report, as appropriate, and any significant supervisory concerns should be reflected in the Matters Requiring Attention and Examination Conclusions sections.

Items Subject to Adverse Classification

Includes assets and off-balance-sheet items which are detailed in the following categories:

Substandard Assets—A Substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful Assets—An asset classified Doubtful has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loss Assets—An asset classified Loss is considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Amounts classified Loss should be promptly charged off.

Summary of Items Subject to Adverse Classification

		ADVERSELY CLASSIFIED			
CATEGORY		Sub-standard	Doubtful	Loss	Total
Loans and Leases					
Securities					
Other Real Estate Owned					
Other Assets					
Other Transfer Risk					
Subtotal					
Contingent Liabilities					
Totals at Current Asset Review	(Date)				
Totals at Prior Asset Review	(Date)				
Totals at Prior Asset Review	(Date)				
Totals at Prior Asset Review	(Date)				

Specific Items Subject to Adverse Classification

	CATEGORY		
Amount, description, and comments	Substandard	Doubtful	Loss

Items Listed as Special Mention

Includes assets and off-balance sheet items which are detailed as follows:

Special Mention Assets–A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in the deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

Summary of Items Listed as Special Mention

	Current asset review	Prior asset review	Prior asset review	Prior asset review
Total Special Mention				

Specific Items Listed for Special Mention

Description	Amount

Assets with Credit Data or Collateral Documentation Exceptions

Include assets with technical defects not corrected during the examination for which deficiency the appropriate number or description is noted in the "Deficiency" column.

1 – Appraisal
2 – Title Search or Legal Opinion
3 – Borrowing Authorization
4 – Recordation
5 – Insurance
6 – Collateral Assignment
7 – Financial Statement
8 – Inadequate Income/Cash Flow Information
9 – Livestock Inspection
10 – Crop Inspection
11 – Other

Name or description	Amount	Date of most recent financial statement	Deficiency description

Template Instruction: The content heading or report page is optional. The content heading is mandatory if examiners' ability to assess the loan files or overall asset quality at the bank is compromised because of inadequate information needed for loan line sheets or if the bank's loan administration systems and processes are deficient, particularly with respect to loan and collateral documentation and collateral values. If the credit-data or collateral-documentation exceptions are materially significant, this content heading or report page should provide support for a discussion of credit-documentation practices under the Asset Quality content heading or report page.

Concentrations

Template Instruction: The content heading or report page is optional. This page is mandatory if there are materially deficient practices in managing concentrations. If included, the content heading should include a discussion of the appropriateness of the bank's risk management practices regarding any materially significant concentrations in assets, liabilities, specific industries, and/or other categories, as applicable. Examiners should include the basis criteria for identifying a specific concentrations. In general, the baseline threshold of a concentration is 25 percent or more of the bank's capital structure (capital structure for the purposes of concentrations being tier 1 capital plus the allowance). For more information, see SR-20-8, "Joint Statement on Adjustment to the Calculation for Credit Concentration Ratios Used in the Supervisory Approach," and the Commercial Bank Examination Manual section entitled, "Concentrations of Credits."

Capital Calculations[14]

Template Instruction: The Capital Calculations page is Optional. Inclusion of capital calculations is mandatory, however, if (1) the bank has a financial subsidiary within the meaning of the Gramm-Leach-Bliley Act, (2) there is a change in the capital category as a results of the examination, or (3) the ratios supporting the capital category in the examination are not derived from the bank's Call Report as of the same date. The third exception could occur if the bank's examination ratios were calculated at a date other than the end of a quarter, or, if calculated at quarter-end, the numbers were adjusted or changed from those filed in the Call Report.

	Current $(000s)	Date $(000s)
Tier 1 Capital		
Common Stock	________	________
Surplus	________	________
Undivided Profits and Capital Reserves	________	________
Does not include appreciation (depreciation) on held-to-maturity and available-for-sale securities.		
Noncumulative Perpetual Preferred Stock & Surplus	________	________
Minority Interests	________	________
Subtotal: Tier 1 Capital Elements	________	________
Less		
Other Adjustments	________	________
Tier 1 Capital		
Tier 2 Capital		
Allowance	________	________
Adjusted Allowance		
Less		
Eligible Allowance	________	________
Cumulative Perpetual Preferred Stock	________	________
Subordinated Debt	________	________
Other	________	________
Tier 2 Capital (Not to Exceed 100% of Tier 1 Capital)		
Total Capital	________	________
Tier 1 Plus Tier 2 Capital	________	________
Less Deductions	________	________
Total Capital		

14. Tier 2 capital and risk-weighted calculations are not required for banks that have qualified for and have opted in to the Community Bank Leverage Ratio framework.

Risk-Weighted Assets and Average Total Assets Calculations

Risk-Weighted Balance Sheet Items		
Risk-Weighted Off-balance-sheet Items		
Less: Risk-Weighted Amounts Deducted from Capital		
Gross Risk-Weighted Assets		
Less: Ineligible Portion of allowance & ATRR		
Total Risk-Weighted Assets		
Average Total Assets		
Less: Amounts Deducted from Tier 1 Capital		
Adjusted Average Total Assets		
Memoranda		
Securities Appreciation (Depreciation)		
Contingent Liabilities/Potential Loss		

Other Matters

Signature of Directors

We the undersigned directors of ______________________________

have personally reviewed the contents of the Report of Examination dated ______________

Signature of Directors	**Date**
______________________________	______________
[Name, Title]	
______________________________	______________
______________________________	______________
______________________________	______________
______________________________	______________
______________________________	______________

NOTE: This form should remain attached to the Report of Examination and be retained in the bank's file for review during subsequent examinations. The signatures of committee members will suffice only if the committee includes outside directors and a Resolution has been passed by the full board delegating the review to such committee.

Confidential Section – Directors and Officers

List alphabetically all directors/trustees, executive officers, and principal stockholders. Also indicate their titles. Number of shares owned is not rounded. (J – indicates stock jointly owned; P – indicates preferred stock owned; H – indicates holding company stock owned; C – indicates stock controlled but not owned). For directors, indicate the area of professional expertise (such as law, marketing, lending, mergers/acquisitions) and the type and date of director training attended.

Name and committees City, State Year of birth	Meetings missed[15]	Years on board	Shares owned	Compensation (Bonus)	Occupation or principal business
Chair					
Directors					
Advisory Directors					
Principal Officers/Not Directors					

15. Number of meetings missed since previous examination.

Regular schedule of directors' meetings ______________________________

Fee paid each director ______________________________

Committees ______________________________

____

____

____

____

Confidential Section – General Information

Include a discussion of strategic plans, future technology plans, planned bank products or services, and/or prospects for the bank; significant or sensitive matters regarding the bank's management not previously addressed; applicable comments on the extent a particular insider controls or dominates the organization and any adverse effect of insiders on operating policies, procedures, or overall financial condition of the bank; and a discussion of any recommendations for supervisory actions and any additional material matters of a sensitive or confidential nature not previously addressed. To the extent not included on the Directors and Officers page, this discussion should also include a list of each major shareholder of the bank (5 percent or more) and the respective percentage of ownership. When the major shareholder is a bank holding company, its major shareholders and the percent controlled should be listed. Include a listing of critical turnkey software vendors, and/or service providers, and any client institutions for which processing services are provided. Include any significant matters of a confidential nature regarding vendors or third-party service providers. In addition, include a listing of e-banking activities. The topics below are provided as examples for examiner consideration.

1. Discuss prospects for the bank including any strategic/technology plans and any new services planned.

2. Discuss any material matters regarding the bank's condition or management that are sensitive or confidential. If applicable, discuss the extent a particular insider controls or dominates the bank and any adverse effect of insiders on operating policies, procedures, or the financial condition of the bank.

3. Discuss any recommendations for supervisory action.

4. List each major (5 percent or more) shareholder or group and their percentage ownership. When the major shareholder is a bank holding company, list its major shareholders and their percent controlled.

Name	Shares Owned	Percent Owned

The Federal Reserve adopted a new framework for the consolidated supervision of large financial institutions on December 17, 2012.[1] The framework strengthens traditional microprudential supervision and regulation to enhance the safety and soundness of individual firms. It also incorporates macroprudential considerations to reduce potential threats to the stability of the financial system and to provide insights into financial market trends. The consolidated supervision framework has two primary objectives:

- *Enhancing resiliency of a firm to lower the probability of its failure or inability to serve as a financial intermediary.*
  Each firm is expected to ensure that the consolidated organization (or the combined U.S. operations in the case of foreign banking organizations) and its core business lines[2] can survive under a broad range of internal or external stresses. This requires financial resilience by maintaining sufficient capital and liquidity, and operational resilience by maintaining effective corporate governance, risk management, and recovery planning.
- *Reducing the impact on the financial system and the broader economy in the event of a firm's failure or material weakness.*
  Each firm is expected to ensure the sustainability of its critical operations[3] and banking offices[4] under a broad range of internal or external stresses. This requires, among other things, effective resolution planning that addresses the complexity and the interconnectivity of the firm's operations.

These objectives are consistent with key provisions of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). These provisions include enhanced prudential standards, which provide the Federal Reserve with the flexibility to tailor the application of these standards to individual firms or groups of firms.[5] (See SR-12-17/CA-12-14 and the supplemental guidance in SR-13-23.)

FRAMEWORK APPLICABILITY

The new framework is designed to support a tailored supervisory approach that accounts for the unique risk characteristics of each firm, including the nature and degree of potential systemic risks inherent in a firm's activities and operations, as well as broader trends across firms. This framework applies to the following institutions:

- *Large Institution Supervision Coordinating Committee (LISCC) firms:* the largest, most complex U.S. and foreign financial organizations subject to consolidated supervision by the Federal Reserve. Nonbank financial companies designated by the Financial Stability Oversight Council (FSOC) for supervision by the Federal Reserve are included in the LISCC portfolio. LISCC firms are considered to pose the greatest systemic risk to the U.S. economy.
  The LISCC is a multidisciplinary body that oversees supervision and evaluates conditions of supervised firms. The committee also develops cross-firm perspectives and monitors interconnectedness and common practices that could lead to greater systemic risk.
- *Large Banking Organizations (LBOs):* domestic bank and savings and loan holding companies with consolidated assets of $50 billion or more that are not included in the LISCC portfolio.
- *Large Foreign Banking Organizations (Large FBOs):* foreign banking organizations with combined assets of U.S. operations of $50 billion or more that are not included in the LISCC portfolio.

In certain instances, the framework applies to the intermediate holding company that is the primary focus of regulations and supervisory activities for the consolidated entity.

1. Refer to the firms described in the subsection on "Framework Applicability."
2. "Core business lines" are those business lines (including associated operations, services, functions, and support) that, in the firm's view, upon failure would result in a material loss of revenue, profit, or franchise value.
3. "Critical operations" are those operations (including associated services, functions, and support) that if they were to fail or be discontinued could pose a threat to the financial stability of the United States.
4. "Banking offices" are defined as U.S. depository institution subsidiaries, as well as the U.S. branches and agencies of foreign banking organizations.
5. 12 USC 5365 and 12 USC 5365(a)(2).

FRAMEWORK OVERVIEW

The supervisory framework comprises the framework's sections' A, B, and C. Sections A and B specify the Federal Reserve's expectations across the following core areas of supervisory focus:

A. Enhancing Resiliency of a Firm
   (1) Capital and Liquidity Planning and Positions
   (2) Corporate Governance
   (3) Recovery Planning
   (4) Management of Core Business Lines
B. Reducing the Impact of a Firm's Failure
   (1) Management of Critical Operations
   (2) Support for Banking Offices
   (3) Resolution Planning
   (4) Additional Macroprudential Supervisory Approaches to Address Risks to Financial Stability
C. Conduct of Supervisory Activities

The Federal Reserve may periodically identify additional supervisory priorities beyond these core areas of focus as necessary to enhance firm-specific supervision and develop cross-firm perspectives.

The subsection on "Conduct of Supervisory Activities" (framework section C) outlines the conduct of supervisory activities used to maintain a comprehensive understanding and assessment of each firm. Effective consolidated supervision requires strong, cooperative relationships between the Federal Reserve and other bank supervisors and functional regulators. The Federal Reserve generally relies to the fullest extent possible on the information and assessments provided by other supervisors and regulators to support effective supervision. Supervisory agencies engaged in the supervision of large financial institutions continue to enhance formal and informal discussions to jointly identify and address key vulnerabilities, and to coordinate supervisory strategies for these firms.

As a general matter, this framework is applicable in circumstances when the consolidated organization and its banking offices are in at least satisfactory condition and there are no material weaknesses or risks across these core areas of supervisory focus. The Federal Reserve applies additional supervisory expectations, and undertakes related activities, to address identified concerns including areas subject to formal or informal enforcement action.

ENHANCING RESILIENCY OF A FIRM (SECTION A)

Capital and Liquidity Planning and Positions

The financial crisis demonstrated the need for stronger regulatory and supervisory assessments of firms' financial resiliency.[6] The Federal Reserve noted significant weaknesses in the adequacy of firms' point-in-time regulatory capital to cover accumulated and prospective risks, as well as in firms' liquidity buffers and risk-management practices.[7] These weaknesses contributed to the failure or near failure of many financial firms and exacerbated the crisis. To support effective capital and liquidity planning, and the adequacy of capital and liquidity positions, each firm should:

a) Maintain strong capital and liquidity positions that not only comply with regulatory requirements, but also support the firm's ongoing ability to meet its obligations to creditors and other counterparties, as well as continue to serve as a financial intermediary through periods of stress.
b) Have in place robust internal processes that enable the firm to maintain capital and liquidity commensurate with its unique risks under normal and stressful conditions, and to provide timely restoration of financial buffers in the event of drawdown.
c) Maintain processes that enable the identification and measurement of potential risks to asset quality, earnings, cash flows, and other primary determinants of capital and liquidity positions.
d) Utilize comprehensive projections of the level and composition of capital and liquidity resources, supported by rigorous and regular stress testing to assess the potential impact of

6. See the Board's final rule on capital plan requirements for large bank holding companies (76 *Fed. Reg.* 74631, December 1, 2011); SR-10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management" (75 *Fed. Reg.* 13656, March 22, 2010); and section 4066.0 of this manual.

7. The capital components of this framework, including those related to stress testing, will apply to savings and loan holding companies after they become subject to minimum regulatory capital requirements.

a broad range of expected and potentially adverse scenarios.
e) Maintain sound risk measurement and modeling capabilities, supported by comprehensive data collection and analysis, independent validation, and effective governance, policies, and controls.[8]
f) Establish goals for capital and liquidity positions that are approved by the firm's board of directors and reflect the potential impact of legal or regulatory restrictions on the transfer of capital or liquidity between legal entities.
g) Maintain independent internal audit and other review functions with appropriate staff expertise, experience, and stature in the organization to monitor the adequacy of capital and liquidity risk measurement and management processes.

Corporate Governance

In order for a firm to be sustainable under a broad range of economic, operational, legal or other stresses, its board of directors (or equivalent for the U.S. operations of FBOs) should provide effective corporate governance with the support of senior management. The board is expected to establish and maintain the firm's culture, incentives, structure, and processes that promote its compliance with laws, regulations, and supervisory guidance. Each firm's board of directors and committees, with support from senior management, should:

a) Maintain a clearly articulated corporate strategy and institutional risk appetite. The board should set direction and oversight for revenue and profit generation, risk management and control functions, and other areas essential to sustaining the consolidated organization.
b) Ensure that the firm's senior management has the expertise and level of involvement required to manage the firm's core business lines, critical operations, banking offices, and other material entities.[9] These areas should receive sufficient operational support to remain in a safe and sound condition under a broad range of stressed conditions.
c) Maintain a corporate culture that emphasizes the importance of compliance with laws and regulations and consumer protection, as well as the avoidance of conflicts of interest and the management of reputational and legal risks.
d) Ensure the organization's internal audit, corporate compliance, and risk management and internal control functions are effective and independent, with demonstrated influence over business-line decision making that is not marginalized by a focus on short-term revenue generation over longer-term sustainability.[10]
e) Assign senior managers with the responsibility for ensuring that investments across business lines and operations align with corporate strategies, and that compensation arrangements and other incentives are consistent with the corporate culture and institutional risk appetite.[11]
f) Ensure that management information systems (MIS) support the responsibilities of the board of directors to oversee the firm's core business lines, critical operations, and other core areas of supervisory focus.

Recovery Planning

Robust recovery planning is central to ensuring the ongoing resiliency of a firm's consolidated operations as well as its core business lines, critical operations, banking offices, and other material entities. Each firm should plan for potential financial or operational weaknesses and identify actions to correct those weaknesses. Therefore, each firm should:

a) Maintain clearly documented quantitative and qualitative criteria that would trigger timely implementation of specific elements of the firm's recovery plan and provide for more rigorous remediation activities if initial actions prove insufficient.
b) Ensure that trigger events reflect a sufficiently broad range of market- and firm-specific stresses across financial, operational, reputational, legal, and compliance risks.
c) Ensure that recovery planning reflects a holistic view of sustainability and resiliency.

8. See SR-11-7, and section 2020.1 of this manual.
9. "Material entities" are subsidiaries or foreign offices of the firm that are significant to the activities of a core business line or critical operation.
10. See SR-08-8/CA-08-11.
11. Refer to "Guidance on Sound Incentive Compensation Policies" (75 *Fed. Reg.* 36395, June 25, 2010) and section 2016.1 of this manual.

Recovery planning should be closely integrated with resolution planning, capital and liquidity planning, and other aspects of financial contingency, crisis management, and business continuity planning.[12]

d) Undertake recovery testing and training exercises that consider a broad range of internal and external risk scenarios and account for interconnectivities across operations and legal entities.
e) Ensure that the recovery plan is updated as needed, and reflects lessons learned from reviews of trigger events, testing, and training exercises.
f) Ensure that recovery planning is sufficiently integrated into corporate governance structures and processes, subject to independent validation, and effectively supported by related MIS reporting to the board and its committees.

Management of Core Business Lines

Effective management of core business lines is essential to ensuring the resilience of the consolidated organization, as these activities are the primary drivers of the firm's revenue generation, profitability, and franchise value. For this reason, a firm's corporate governance should extend (as discussed in the subsection on ''Corporate Governance'' (*framework section A.2*)) to the management of each core business line. Each core business line should have:

- Business-line senior management with qualifications and experience commensurate with the size and complexity of related activities and operations;
- A strategic planning process that ensures areas of growth and innovation are effectively managed;
- Appropriate compensation and other incentives that are consistent with the institutional risk appetite and in compliance with laws and regulations;
- An independent and strong risk-management framework that supports identification, measurement, assessment, and control of the full spectrum of risks; and
- Timely identification and resolution of audit, compliance, and regulatory issues

REDUCING THE IMPACT OF A FIRM'S FAILURE (SECTION B)

Management of Critical Operations

The failure or discontinuance of any of a firm's critical operations could weaken the U.S. economy or pose a threat to the financial stability of the United States. Each of the supervisory expectations outlined around management of core business lines (see the subsection on ''Management of Core Business Lines'' (*framework section A.4*)) applies equally to management of critical operations to ensure their financial and operational resilience. Additionally, each firm should ensure that critical operations are sufficiently resilient to be maintained, continued, and funded even in the event of failure or material financial or operational distress. These expectations should be fully reflected in recovery and resolution planning.

Support for Banking Offices

The Federal Reserve's consolidated supervision program has historically focused on protecting the safety and soundness of U.S. depository institution subsidiaries of bank holding companies and the U.S. branches and agencies of foreign banking organizations (collectively defined as banking offices). This is due to the risks posed by banking offices' access to the federal safety net. Specifically, these offices pose risks to the payment system, the Federal Reserve's discount window, and—in the case of most U.S. depository institutions—federal deposit insurance funds.

A consolidated organization should serve as a source of financial and managerial strength to its banking offices. The activities of the parent company and affiliated nondepository subsidiaries should not present material risks to affiliated banking offices, the consolidated organization itself, or to the consolidated organization's ability to support its banking offices.[13] Each firm should:

12. Business continuity expectations include adherence with expectations set forth in SR-03-9, including the geographic diversity and resiliency of data centers and operations, and testing of recovery and resumption arrangements.

13. Due to structural differences, there are important distinctions in the forms of support provided to U.S. depository institution subsidiaries versus those provided to the U.S.

a) Provide for the strength and resiliency of its banking offices, ensuring prompt financial and operational support so that each office remains in a safe and sound condition under a broad range of stressed conditions.
b) Ensure that the activities of the parent company and nondepository institution subsidiaries do not present undue direct or indirect risks to the safety and soundness of banking offices. This includes the transmission of financial, operational, legal, compliance, or reputational risks that may undermine public confidence in the financial strength of its banking offices.
c) Maintain sufficient liquidity, cash flow, and capital strength at the parent company and nondepository institution subsidiaries to service debt obligations and cover fixed charges. The parent company needs to consider whether there are any legal or regulatory restrictions on financial transfers between legal entities within the organization.
d) Implement and maintain effective policies, procedures, and systems to ensure compliance with applicable laws and regulations. This includes compliance with respect to covered transactions subject to the Board's Regulation W, which implements sections 23A and 23B of the Federal Reserve Act and limits a bank's transactions with its affiliates.[14]

Resolution Planning

To promote financial stability, the Dodd-Frank Act requires each bank holding company with consolidated assets of $50 billion or more, as well as nonbank financial companies designated by the FSOC, to develop and maintain plans for rapid and orderly resolution in the event of material financial distress or failure. These plans should be utilized as an element of the firm's strategic planning and address the complexity and interconnectivity of the firm's operations.[15]

The Federal Reserve and the FDIC jointly review a firm's resolution plan relative to supervisory requirements, including:

a) The firm's strategic analysis describing its plans for rapid and orderly resolution under the U.S. Bankruptcy Code (or other relevant insolvency regimes). This strategy must not pose systemic risk and must exclude reliance on extraordinary support from the United States or any other government to prevent failure of the firm.
b) The firm's strategy for maintaining and funding material entities, critical operations, and core business lines in the event of material financial distress.
c) Analysis of potential impediments to resolution, and actions to make the firm more resolvable or otherwise reduce its complexity and interconnectivity.
d) Analysis of whether the failure of a major counterparty would likely result in the material financial distress or failure of the firm.
e) The manner and extent to which an insured depository subsidiary is adequately protected from risks arising from the activities of non-depository subsidiaries.
f) For a U.S. firm with foreign operations, its strategy for addressing the risks arising from these foreign operations to its U.S. operations, and its ability to maintain core business lines and critical operations in foreign jurisdictions.
g) Analysis of whether resolution planning is sufficiently integrated into corporate governance structures and processes, subject to independent validation, and effectively supported by related MIS reporting to the board of directors and its committees.

Additional Macroprudential Supervisory Approaches to Address Risks to Financial Stability

The financial crisis demonstrated that too narrow a focus on the safety and soundness of individual firms can result in a failure to detect and address emerging threats to financial stabil-

branches and agencies of foreign banks. For example, branches/agencies do not hold capital and have differing business and liquidity profiles, governance mechanisms, and regulatory requirements than depository institutions. Therefore, the Federal Reserve will consider these differences in its implementation of this supervisory framework for the U.S. branches and agencies of FBOs, and expects parent FBOs and their U.S. branches and agencies to do the same. The extent of supervisory activity undertaken to assess the adequacy of parent company support for U.S. branches and agencies of FBOs is scaled to the condition, size, and interconnectedness of these offices.

14. See SR-03-2, and section 4050.1 of this manual.

15. Refer to 12 C.F.R. 243 (Federal Reserve) and 12 C.F.R. 381 (FDIC) for the ''Resolution Plans Required'' regulations. See also, 76 *Fed. Reg.* 67323, November 1, 2011.

ity that arise across many firms. The Dodd-Frank Act requires the Federal Reserve to consider the broader risks to financial stability posed by individual companies and through the interconnectedness among these companies. See section 1040.0.3 of this manual.

The Federal Reserve aims to reduce systemic risks by increasing the capacity of firms and markets to absorb shocks when problems occur, and by reducing potential costs in the event of financial distress or failure of a systemically important institution. Supervision carried out under this framework will support a variety of macroprudential supervisory approaches beyond those already discussed, including:

a) Using insights developed through microprudential supervision and related data collection and analysis to identify, understand, and assess potential systemic risks. Areas of review could include, for example, emerging trends in critical operations, interconnectedness, rapidly expanding markets, cyclical industries, and financial products lacking substitutes or effecting large market segments.
b) Identifying potential risks to financial stability indicated by the information in supervisory stress tests and through trends in scenarios employed by firms in their internal stress tests.
c) Using comparative and aggregate analysis to monitor industry practices, common investment or funding strategies, changes in degree or form of financial interconnectedness, or other developments with implications for financial stability.
d) Coordinating with the Federal Reserve's supervision of systemically important financial market utilities to identify and address risks related to payment, clearing, and settlement activities, as well as to identify potential structural vulnerabilities.
e) Working closely with the FSOC and other regulators and supervisors to support the designation and supervision of systemically important nonbank firms, and to enhance the monitoring of systemic risk.
f) Enhancing international coordination with foreign counterparts, including national supervisors and international bodies such as the Basel Committee on Bank Supervision, the Financial Stability Board, and the Senior Supervisors Group. These activities focus on enhancing oversight of internationally active financial firms and markets and on minimizing the opportunities for firms to take advantage of weaker or inconsistent regulations.

CONDUCT OF SUPERVISORY ACTIVITIES (SECTION C)

The Federal Reserve uses a range of supervisory activities to maintain a comprehensive understanding and assessment of each firm, including:

a) Coordinated horizontal reviews involve examination of several institutions simultaneously, encompassing firm-specific supervision and the development of cross-firm perspectives. The Federal Reserve recognizes the priority of these reviews through the dedication of multidisciplinary skills and experienced staff. Examples include analysis of capital adequacy and planning via the Comprehensive Capital Analysis and Review (CCAR), as well as horizontal evaluations of resolution plans and incentive compensation practices.
b) Firm-specific examination and continuous monitoring activities[16] are undertaken to maintain an understanding and assessment across the core areas of supervisory focus for each firm. These activities include review and assessment of changes in strategy, inherent risks, control processes, and key personnel, and follow-up on previously identified concerns (for example, areas subject to enforcement actions or other supervisory issues, or emerging vulnerabilities).
c) In developing and executing a detailed supervisory plan for each firm, the Federal Reserve generally relies to the fullest extent possible on the information and assessments provided by other relevant supervisors and functional regulators. The Federal Reserve actively participates in interagency information sharing and coordination, consistent with applicable laws, to promote comprehensive and effective supervision and limit unnecessary duplication of information requests. Supervisory agencies continue to enhance for-

16. ''Continuous monitoring activities'' include meetings with a banking organization's management; analysis of internal MIS reports, market indicators, and other internal and external information; review of internal and external audit findings; and coordination with other relevant supervisors and functional regulators and utilization of their work as appropriate.

mal and informal discussions to jointly identify and address key vulnerabilities, and to coordinate supervisory strategies for large financial institutions.

d) In certain instances, supervisors may be able to rely on a firm's internal audit or internal control functions in developing a comprehensive understanding and assessment.

APPENDIX A—RISK TRANSFER CONSIDERATIONS WHEN ASSESSING CAPITAL ADEQUACY

The following discussion, SR-13-23, provides supplemental guidance to SR-12-17/CA-12-14 pertaining to the latter's supervisory focus on an institution's capital adequacy and liquidity sufficiency. The supplemental guidance centers on how certain risk transfer transactions affect assessments of capital adequacy at large financial institutions (referred to hereafter as a firm).[17] It provides clarification on supervisory expectations when assessing a firm's capital adequacy in certain circumstances when the risk-based capital framework may not fully capture the residual risks of a transaction.[18]

Risk-mitigation techniques can reduce a firm's level of risk. In general, the Federal Reserve views a firm's engagement in risk-reducing transactions as a sound risk-management practice. There are, however, certain risk-reducing transactions for which the risk-based capital framework may not fully capture the residual risks that a firm faces on a post-transaction basis. As a result of inquiries and discussions with market participants, the Federal Reserve has identified specific characteristics of risk transfer transactions that give rise to this concern and on which further guidance is needed, including cases in which

- a firm transfers the risk of a portfolio to a counterparty (which may be a thinly capitalized special purpose vehicle (SPV)) that is unable to absorb losses equal to the risk-based capital requirement for the risk transferred; or
- a firm transfers the risk of a portfolio to an unconsolidated, "sponsored" affiliate entity of the firm (which also may be an SPV).

In cases involving unaffiliated counterparties, while the transactions may result in a significant reduction in a firm's risk-weighted assets and associated capital requirements under the regulatory capital framework, the firm may nonetheless face residual risks. These residual risks arise because the effectiveness of a firm's hedge involving a thinly capitalized SPV counterparty would be limited to the loss absorption capacity of the SPV itself. In cases involving unconsolidated "sponsored" affiliates of the firm, the residual risk arises from the implicit obligation the sponsoring firm may have to provide support to the affiliate in times of stress. SR-13-23 addresses how the Federal Reserve supervisory staff will view such risk-reducing transactions[19] in evaluating a firm under the Board's capital plan rule and the associated annual Comprehensive Capital Analysis and Review (CCAR).[20]

In the case of a risk transfer transaction with a non-affiliated, limited-recourse SPV or other counterparty with limited loss-absorption capacity, Federal Reserve supervisory staff will evaluate the difference between the amount of capital required for the hedged exposures before the risk transfer transaction and the counterparty's loss-absorbing resources. When evaluating capital adequacy, including in the context of CCAR, supervisory staff will evaluate whether a firm holds sufficient capital in addition to its minimum regulatory capital requirements to cover this difference.[21] In addition, when a firm engages in such a risk transfer transaction, the firm should be able to demonstrate that it reflects the residual risk in its internal assessment of capital adequacy and maintains sufficient capital to address such risk. In this regard, a commitment

17. This guidance applies to large financial institutions that are domestic bank and savings and loan holding companies with consolidated assets of $50 billion or more and foreign banking organizations with combined assets of U.S. operations of $50 billion or more.

18. See 12 CFR 217. The risk-based capital framework establishes risk-based and leverage capital requirements for banking organizations, including top-tier savings and loan holding companies, except those that are substantially engaged in insurance underwriting or commercial activities. The guidance in this letter would apply to such entities at such time as risk-based and leverage capital requirements become applicable to them.

19. While the cases described are examples, the principles set forth should apply to other transactions that call into question the degree to which risk transfer has occurred.

20. See 12 CFR 225.8(d)(2)(i). For additional guidance on CCAR, refer to the Federal Reserve's website at www.federalreserve.gov/bankinforeg/ccar.htm. The capital plan rule and CCAR apply only to bank holding companies with total consolidated assets of $50 billion or more.

21. Supervisory staff may also analyze whether the counterparty has liabilities in addition to the specific risk transfer transaction.

by a third party to provide additional capital in a period of financial stress would not be counted toward the loss-absorbing capacity of the counterparty.

> *Example:* A firm has a $100 portfolio that has a capital requirement of $8. If the firm undertakes a transaction to transfer the risk of this portfolio to an unaffiliated SPV with paid-in capital of $3, then the firm would need to be able to demonstrate that, in addition to meeting its minimum regulatory capital requirements, the firm has sufficient capital to cover the $5 difference between the SPV's capital and the capital requirement associated with the portfolio.

In the case of risk transfer to an unconsolidated, ''sponsored'' affiliated entity, the nature of the firm's relationship with the entity calls into question the degree of risk transfer in the transaction. Firms are discouraged from entering into such transactions, which generally do not involve effective risk transfer because of the sponsored entity's ongoing relationship with the firm and, as noted above, the implicit obligation that the firm may have to provide capital to the sponsored entity in a period of financial stress affecting the sponsored entity. Firms engaging in such transactions should presume for the purpose of their internal capital adequacy assessment as well as for capital planning purposes that no risk transfer has occurred.

Supervisors will strongly scrutinize risk transfer transactions that result in substantial reductions in risk-weighted assets, including in supervisors' assessment of a firm's overall capital adequacy, capital planning, and risk management through CCAR. Based on an assessment of the risks retained by the firm, the Board may in particular cases determine not to recognize a transaction as a risk mitigant for risk-based capital purposes.[22] Firms should bring these types of risk transfer transactions to the attention of their senior management and supervisors. Supervisors will evaluate whether a firm can adequately demonstrate that the firm has taken into account any residual risks in connection with the transaction.

APPENDIX B—MANAGING FOREIGN EXCHANGE SETTLEMENT RISKS FOR PHYSICALLY SETTLED TRANSACTIONS

The Federal Reserve notes that the Basel Committee on Banking Supervision (Committee), with input from the Federal Reserve,[23] published ''Supervisory Guidance for Managing Risks Associated with the Settlement of Foreign Exchange Transactions'' (guidance) in February 2013. This guidance sets forth seven principles or ''guidelines'' for managing foreign exchange transaction-settlement risks. The Federal Reserve considers this guidance on foreign exchange settlement risks to be a component of its current, broad-based focus on banking institutions' foreign exchange activities.

The Federal Reserve supports these principles as part of its continuing effort to promote the global financial system's ability to withstand severe market disruptions, and has determined that the institutions subject to SR-13-24 (covered institutions)[24] should apply the seven guidelines, which are summarized below (see sections 3.1 through 3.7 of the guidance), to their foreign exchange activities, with the following clarifications regarding application of the guidance in the United States.[25]

22. See generally 12 CFR 217.1(d)(1), (d)(3), and (d)(5). In addition, under the Board's current capital adequacy guidelines for bank holding companies and state member banks (banking organizations), the Board may determine that the regulatory capital treatment for a banking organization's exposure or other relationship to an entity not consolidated on the banking organization's balance sheet is not commensurate with the actual risk relationship of the banking organization to the entity. In making this determination, the Board may require the banking organization to treat the entity as if it were consolidated onto the balance sheet of the banking organization for risk-based capital purposes and calculate the appropriate risk-based capital ratios accordingly, all as specified by the Board. 12 CFR parts 208 and 225, Appendix A, section I.

23. This guidance applies to large financial institutions supervised by the Federal Reserve, as defined in SR-12-17/CA-12-14. This guidance does not apply to community and regional banking organizations, defined as those with less than $50 billion in total consolidated assets, unless the banking organization engages in significant foreign exchange activities.

24. While the Committee's guidance uses the term ''bank,'' for purposes of SR-13-24, ''covered institutions'' are those defined in SR-12-17/CA-12-14 as Large Institution Supervision Coordinating Committee (LISCC) firms, large banking organizations (LBOs), and U.S operations of large foreign banking Organizations (large FBOs), as well as any other banking organization that engages in significant foreign exchange activities.

25. The guidance applies to foreign exchange transactions that consist of two settlement payment flows. This includes spot transactions, forwards, swaps, deliverable options, and

- *Guideline 1—Governance.* A bank should have strong governance arrangements over its foreign exchange settlement-related risks, including a comprehensive risk-management process and active engagement by the board of directors.

  Paragraph 3.1.8 of the guidance states that the board of directors of a covered institution should oversee the management of the compliance function associated with settling foreign exchange transactions. For purposes of the application of the guidelines by covered institutions, senior management should routinely communicate significant compliance matters to the board of directors. The board of directors may choose to delegate regular oversight to a single board member or a committee of the board.
- *Guideline 2—Principal risk.* A bank should use financial market infrastructures that provide payment-versus-payment settlement to eliminate principal risk when settling foreign exchange transactions. Where payment-versus-payment settlement is not practicable, a bank should properly identify, measure, control, and reduce the size and duration of its remaining principal risk.
- *Guideline 3—Replacement-cost risk.* A bank should employ prudent risk-mitigation regimes to properly identify, measure, monitor, and control replacement-cost risk for foreign exchange transactions until settlement has been confirmed and reconciled.

  Paragraph 3.3.7 of the guidance refers to transactions with affiliates. Covered institutions are encouraged to exchange variation margin for inter-affiliate transactions as a matter of sound business practice.
- *Guideline 4—Liquidity risk.* A bank should properly identify, measure, monitor, and control its liquidity needs and risks in each currency when settling foreign exchange transactions.
- *Guideline 5—Operational risk.* A bank should properly identify, assess, monitor, and control its operational risks. A bank should ensure that its systems support appropriate risk-management controls, and have sufficient capacity, scalability, and resiliency to handle foreign exchange volumes under normal and stressed conditions.
- *Guideline 6—Legal risk.* A bank should ensure that agreements and contracts are legally enforceable for each aspect of its activities in all relevant jurisdictions.

  Paragraph 3.6.2 of the guidance states that institutions conducting business in multiple jurisdictions should identify, measure, monitor, and control for the risks arising from conflicts of laws across jurisdictions and suggests accomplishing these objectives by obtaining legal opinions from qualified internal or external counsel. The Federal Reserve does not expect a covered institution to obtain a legal opinion for every transaction; rather, management should seek legal advice that addresses standardized terms, master netting and other significant agreements, and individual transactions as appropriate.
- *Guideline 7—Capital for foreign exchange transactions.* When analyzing capital needs, a bank should consider all foreign exchange settlement-related risks, including principal risk and replacement-cost risk. A bank should ensure that sufficient capital is held against these potential exposures, as appropriate.

While the Federal Reserve acknowledges the principles set forth in section 3.7 of the guidance, and in particular that all risks related to the settlement of foreign exchange transactions should be considered in determining capital needs under the applicable capital framework, the guidance does not and is not intended to modify the calculation of regulatory capital requirements for covered institutions.

currency swaps involving exchange of principal. It excludes instruments that involve one-way settlement payments, such as non-deliverable forwards, non-deliverable options, and contracts for difference. The Federal Reserve expects that the guidance will be applied broadly by the covered institutions and notes that there may be limited instances in which an institution need not apply this guidance to an insignificant currency exposure.

INTRODUCTION

This section provides a brief overview of the Federal Reserve's policies, practices, and procedures relating to the examination of domestic and international banking departments of state-chartered commercial banks that are members of the Federal Reserve (state member banks or SMBs). The Federal Reserve also has certain supervisory and oversight responsibilities in other areas of banking, both domestic and international, for which it has developed specialized examination procedures, conducts on-site examinations, and generally completes separate examination reports.[1] These other areas of banking, such as information technology, Bank Secrecy Act (BSA) and anti-money-laundering (AML) compliance, and consumer compliance are not covered in depth in this manual. Federal Reserve policies and examination procedures relating to each of these areas are covered in either separate manuals, such as the *Federal Financial Institution Examination Council (FFIEC) Information Technology Examination Handbook*, *FFIEC BSA/AML Examination Manual*, and the *Consumer Compliance Handbook*, or supervisory letters (SR letters) issued by the Federal Reserve.

HOLDING COMPANIES

The Federal Reserve has the sole responsibility for supervising bank holding companies (BHCs) and savings and loan holding companies (SLHCs). These organizations control commercial banks and thrifts that hold most of the insured commercial banking assets in the United States. Substantially, all BHCs and SLHCs are subject to an examination or inspection by Federal Reserve examiners.

Since 2004, the Federal Reserve has used the "RFI/C(D)" rating system (RFI rating system) to communicate its supervisory assessment of BHCs regardless of their asset size, complexity, or systemic importance. In 2018, the Board adopted the RFI rating system for non-insurance and noncommercial SLHCs with less than $100 billion in total consolidated assets.[2] At the same time, the Board also adopted a rating system for BHCs and non-insurance and non-commercial SLHCs with total consolidated assets of $100 billion or more (referred to as the LFI rating system).[3] The LFI rating system also applies to U.S. intermediate holding companies of foreign banking organizations with combined U.S. assets of $50 billion or more established pursuant to the Federal Reserve's Regulation YY.

INTERNATIONAL

Overseas Operations of U.S. Banking Organizations

The Federal Reserve has broad discretionary powers to regulate the foreign activities of member banks and BHCs so that, in financing U.S. trade and investments abroad, these U.S. banking organizations can be competitive with institutions of the host country without compromising the safety and soundness of their U.S. operations.[4] Under provisions of the Federal Reserve Act and the Board's Regulation K, SMBs may establish branches in foreign countries subject to, in most cases, the Board's prior approval. Furthermore, Section 25 of the Federal Reserve Act permits the Board to order special examinations of foreign branches, banks or corporations as it may deem best. However, the Federal Reserve's examinations of a SMB's overseas operations and activities are usually conducted at the head office in the United States, where the ultimate responsibility for the overseas activities and facilities may lie. To adequately supervise international operations, examiners and supervisory staff should continuously monitor the bank's international activities to

1. The Federal Reserve generally refers to supervisory activities of holding companies as inspections, rather than examinations.

2. See SR letter 19-4/CA letter 19-3, "Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than $100 billion," and SR letter 13-21, "Inspection Frequency and Scope Requirements for Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of $10 Billion or Less," for more information on the inspection scope and frequency of holding companies with less than $100 billion in assets.

3. See SR letter 19-3/CA letter 19-2, "Large Financial Institution Ratings."

4. For more information, see the "International Banking Activities," section in the *Bank Holding Company Supervision Manual*.

understand and assess the extent of its international strategy, trends, operations, and legal-entity structure as well as related governance, risk management, and internal controls.

Edge Act and Agreement Corporations

Under Sections 25 and 25A of the Federal Reserve Act, Edge Act and agreement corporations may engage in international banking and foreign financial transactions, and the Federal Reserve is responsible for conducting examinations of these entities and their branches. (See Regulation K, 12 CFR 211.) Edge corporations are chartered by the Board to conduct an international banking business. Agreement corporations are state-chartered companies that enter into an agreement with the Board to limit their operations to international banking. These corporations, which are usually subsidiaries of SMBs, provide their owner organizations with additional powers in two areas: (1) they may conduct a deposit and loan business in states other than that of the parent, provided that the business is strictly related to international transactions and (2) they have somewhat broader foreign-investment powers than SMBs, being able to invest in foreign financial organizations, such as finance companies and leasing companies, as well as in foreign banks.

U.S. Activities of Foreign Banking Organizations

Foreign entities have operations in the United States and are a significant element in the U.S. banking system. The Federal Reserve has significant authority over foreign banking organizations (FBOs). Its role was enhanced by the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA). The Federal Reserve has broad oversight authority for the supervision and regulation of FBOs that engage in banking in the United States through branches, agencies, commercial lending companies, and subsidiary banks. In fulfilling this responsibility, the Federal Reserve conducts its own examinations and shall rely, to the fullest extent possible, on the reports of examination made by the primary federal or state supervisor of the branch or agency of the foreign bank.

Section 10(d) of the Federal Deposit Insurance Act (FDI Act) generally requires the appropriate federal banking agency for an insured depository institution (IDI) to conduct a full-scope, on-site examination at least once every 12 months, but permits a longer examination cycle—at least once every 18 months—for IDIs that meet certain criteria, including the requirement that the IDI must have total assets below a specified amount. Section 210 of the Economic Growth, Regulatory Relief, and Consumer Protection Act amends section 10(d) of the FDI Act to increase from \$1 billion to \$3 billion the total asset threshold below which an IDI may qualify for the 18-month examination cycle.

On December 28, 2018, the Board published final rules that adopted without change interim final rules that (1) amended Regulation H to increase, from \$1 billion to \$3 billion, the total asset threshold under which the Board may apply an 18-month on-site examination for an SMB; and (2) amended, similarly, Regulation K, which governs the on-site examination cycle for Board-supervised U.S. branches and agencies of foreign banks, consistent with section 7(c)(1)(C) of the International Banking Act of 1978.[5] The Board also made a determination that amending the \$1 billion threshold to \$3 billion would be consistent with safety and soundness principles per 10(d)(10) of the FDI Act.

Amendments to Regulation K parallel the amendments to Regulation H. Under the final rules, a U.S. branch or agency of a foreign bank with less than \$3 billion in total assets may be eligible for an 18-month on-site examination cycle if it received, at its most recent examination, a composite condition rating of "1" or "2" under the supervisory rating system (see SR letter 00-14, "Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations")[6] and if it satisfies the following criteria:

1) Either: (a) the foreign bank's most recently reported capital adequacy position consists of, or is equivalent to, tier 1 and total risk-based capital ratios of at least 6 percent and 10 percent, respectively, on a consoli-

5. The interim final rules were effective August 28, 2018. See 83 Fed. Reg. 43,961 (August 29, 2018). The final rules were effective January 28, 2019. See 83 Fed. Reg. 67,033 (December 28, 2018).

6. SR-00-14 describes the ROCA rating system. The ROCA system represents a rating of the risk management, operational controls, compliance, and asset quality of an FBO's U.S. activities.

dated basis; *or* (b) the branch or agency has maintained on a daily basis, over the past three quarters, eligible assets in an amount not less than 108 percent of the preceding quarter's average third-party liabilities (determined consistent with applicable federal and state law) and sufficient liquidity is currently available to meet its obligations to third parties;
2) The branch or agency is not subject to a formal enforcement action or order by the Board, Federal Deposit Insurance Corporation, or Office of the Comptroller of the Currency; and
3) The branch or agency has not experienced a change in control during the preceding 12-month period in which a full-scope, on-site examination would have been required but for the 18-month examination cycle eligibility provision.[7]

The Federal Reserve may consider additional factors when determining the eligibility of a U.S. branch or agency of a foreign bank for an 18-month examination cycle, including whether (1) any of the individual components of the ROCA rating system of a branch or agency of a foreign bank is rated "3" or worse; (2) the results of any off-site surveillance indicate a deterioration in the condition of the branch or agency; (3) the size, relative importance, and role of a particular branch or agency in the context of the foreign bank's entire U.S. operations otherwise necessitate an annual examination; and (4) the condition of the foreign bank gives rise to such a need.[8] Refer to SR letter 18-7, "Updates to the Expanded Examination Cycle for Certain State Member Banks and U.S. Branches and Agencies of Foreign Banking Organizations."

The FBSEA also requires Federal Reserve approval for establishment of new FBO offices in the United States, and it gives the Federal Reserve the authority to terminate such offices.

INFORMATION TECHNOLOGY ACTIVITIES

The Federal Reserve is responsible for conducting information technology (IT) examinations of SMBs, FBOs, and Edge Act corporations. Section 3 of the Bank Service Corporation Act (12 USC 1863, re-designated as the Bank Service Company Act) generally authorizes bank service companies to perform significant clerical, bookkeeping, or accounting functions, such as demand-deposit accounting and loan processing. Section 7 of the Bank Service Company Act (12 USC 1867) empowers the appropriate federal regulatory agency to examine banking services and operations regardless of whether these services are performed on or off the premises of a particular financial institution. When a financial institution contracts with an external company to provide data processing services, the third-party technology service provider's activities that pertain to financial institutions are subject to examination. Larger companies that operate in more than one regulatory district or region are examined pursuant to the Significant Service Provider (SSP) examination program. IT examinations, whether of independent processing companies or an SMB's own IT functions, are operational in nature and focus on evaluations of internal controls and audit effectiveness. IT examiners have experience that enables them to assess the performance of each data center in four critical functions: audit, management, systems development and programming, and computer operations.

TRUST DEPARTMENTS AND TRANSFER AGENT ACTIVITIES

The Federal Reserve examines trust departments of SMBs, state-chartered trust companies that are members of the Federal Reserve System, and certain nondepository trust company subsidiaries of holding companies. The Federal Reserve also has a program of examinations for those trust companies not supervised by any other federal banking agency. In addition, examinations are conducted of Edge Act corporations that conduct foreign trust or fiduciary services, in accordance with Regulation K (12 CFR 211). These examinations determine whether the trust functions are conducted in accordance with applicable fiduciary principles and with other appropriate laws and regulations. The federal banking agencies originally adopted the Uniform Interagency Trust Rating System (UITRS) in 1978 to evaluate the fiduciary activities of financial institutions on a uniform basis. The FFIEC issued

7. 12 CFR 211.26(c).
8. 12 CFR 211.26(c)(2)(ii).

modifications to the UITRS in 1998, in part, to align the UITRS rating definitions with existing safety and soundness ratings definitions and to emphasize the importance of sound risk-management processes.

To engage in providing trust or fiduciary services, a bank must have proper authorization under state or federal law. Under the laws of most states, this requires a specific approval of the state financial supervision agency. Similarly, pursuant to the Board's Regulation H (12 CFR 208.3(d)(2)), the Board's permission must be obtained before changing the general character of a bank's business.

Transfer agents record changes of owners of a security, maintain the issuer's security holder records, cancel and issue certificates, and distribute dividends. An SMB, a subsidiary thereof or a holding company conducting transfer agent activities, is required to register as a transfer agent with the Federal Reserve. Federal Reserve examiners conduct separate examinations of, and complete separate reports for, the transfer-agency activities of those SMBs and BHCs that are registered with the Federal Reserve as transfer agents.

MUNICIPAL SECURITIES DEALERS, GOVERNMENT SECURITIES DEALERS, AND CLEARING AGENCIES

As a result of the Securities Act Amendments of 1975, the Board is responsible for supervising SMBs and BHCs that act as municipal securities dealers or clearing agencies. Federal Reserve examiners conduct separate examinations of and complete separate reports for both of these activities. A bank, a separate department or division of a bank, or a holding company is required to register as a municipal securities dealer if it deals in municipal securities for its own account other than in a fiduciary capacity.

The Government Securities Act of 1986 (GSA), as amended, gives the Federal Reserve responsibility for examining the government securities activities of an SMB, foreign bank, state branch or state agency of a foreign bank, or commercial lending company owned or controlled by an FBO, or Edge Act or agreement corporation. The GSA requires all government securities brokers or dealers to register with the U.S. Securities and Exchange Commission. Government securities brokers and dealers receive specialized examinations to determine compliance with the GSA. For banks that have a lower level of government securities activities, compliance with the GSA is determined as part of the commercial examination.

The responsible Federal Reserve staff conducting the examination need to fully consider their supervisory responsibilities under the GSA in formulating their supervisory plans and conducting risk-focused examinations. In this regard, two key factors should be considered concerning government securities custodial activities. First, all depository institutions that hold government securities for customers, including securities under repurchase agreements, are subject to the U.S. Department of Treasury's GSA custody rules. Second, certain financial institutions that are exempt from the definition of a government securities broker or dealer are, nevertheless, subject to the U.S. Department of Treasury's government securities broker or dealer custody rules when they engage in hold-in-custody repurchase agreements. Under such agreements, the financial institution retains custody of securities that are the subject of a repurchase agreement between the financial institution and a counterparty.[9] These issues are more fully described in the examination procedures pertaining to government securities activities.

Reserve Bank staff are to separately report to Board staff only the results of reviews of government securities broker-dealer activities (and such broker-dealer's related custodial activities). See SR letter 06-8, "Reports of Examinations of Government Securities Activities," and its attachment, which includes the instructions for the report's transmittal. When preparing these reports, Reserve Banks have the option of either using the Summary Report of Examination of Government Securities Broker-Dealer Activities and Custodial Activities (GSB-D report) or forwarding a copy of the relevant section of the examination report that contains the same information as required in the GSB-D report.

A clearing agency acts as a custodian of securities for the settlement of securities transactions by bookkeeping entries. Separate report-

9. See the U.S. Department of Treasury's regulation on Custodial Holdings of Government Securities by Depository Institutions, which governs holdings of government securities for customers, except those held in a fiduciary capacity (17 CFR 450.3).

ing on the GSB-D form is not required for a government securities custodian that engages in hold-in-custody repurchase agreements but which is otherwise exempt from filing notice as a government securities broker or dealer. See the U.S. Department of Treasury's regulation on Protection of Customer Securities and Balances (17 CFR 403.5(a) and (d)), and SR letter 93-40, "Department of the Treasury Interpretation Regarding Allocation of Securities to Customer Accounts in Hold-in-Custody Repurchase Transactions."

CONSUMER EXAMINATIONS

Some banking laws, such as the Truth in Lending Act and the Truth in Savings Act, require banks to disclose information that helps consumers evaluate product options open to them. Other laws (for example, the Community Reinvestment Act and the Equal Credit Opportunity Act) require banks to help meet the credit needs in their communities and promote the availability of credit to all creditworthy applicants. Finally, laws such as the Fair Credit Reporting Act and the Fair Debt Collection Act provide consumer safeguards for the extension, collection, and reporting of consumer credit. At the Federal Reserve, specialized examiners conduct examinations to determine banks' compliance with these laws and their implementing regulations.

In 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which established the Consumer Financial Protection Bureau (CFPB). Under the Dodd-Frank Act, the CFPB has authority to examine IDIs and insured credit unions with consolidated assets of more than $10 billion and their affiliates, to assess compliance with the requirements of 18 enumerated federal consumer financial laws, and to assess risks to consumers and financial markets from consumer financial products and services. The Federal Reserve has consumer compliance supervisory responsibility for (1) SMBs with consolidated assets of more than $10 billion for their compliance with consumer protection laws not specifically assigned to the CFPB, and (2) SMBs with consolidated assets of $10 billion or less for their compliance with all consumer protection laws. The Federal Reserve is also responsible for conducting Community Reinvestment Act examinations for SMBs, regardless of asset size.

Table 1
Other Types of Examinations and Relevant Guidance

Examination Type or Examined Entity	*Relevant Guidance*
Holding Companies	• Federal Reserve's *Bank Holding Company Supervision Manual* • SR-19-4/CA-19-3, "Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than $100 Billion" • SR-19-3/CA-19-2, "Large Financial Institution Ratings" • SR-13-21, "Inspection Frequency and Scope Requirements for Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of $10 Billion or Less"
Overseas Operations of U.S. Banking Organizations	• Sections 1050.1 and 1050.2 of the *Bank Holding Company Supervision Manual* • SR-08-9, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations"

Examination Type or Examined Entity	*Relevant Guidance*
Edge Act and Agreement Corporations	• SR-08-9, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations" • SR-90-21, "Rating System for International Examinations"
U.S. Activities of Foreign Banking Organizations	• SR-12-17/CA-12-14, "Consolidated Supervision Framework for Large Financial Institutions" • SR-08-9, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations" • SR-00-14, "Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations" • SR-96-36, "Guidance on Evaluating Activities Under the Responsibility of U.S. Branches, Agencies and Nonbank Subsidiaries of Foreign Banking Organizations (FBOs)"
Information Technology Examinations	• *FFIEC Information Technology Examination Handbook* • The Information Technology section of this manual • SR-00-3, Information Technology Examination Frequency" • SR-99-8, "Uniform Rating System for Information Technology"
Trust Departments and Transfer Agent Activities	• The Fiduciary Activities section of this manual • SR-01-5, "Examination of Fiduciary Activities" • SR-98-37, "Uniform Interagency Trust Rating System" • SR-96-10, "Risk-Focused Fiduciary Examinations"
Municipal Securities Dealers Government Securities Dealers Clearing Agencies	• SR-06-8, "Reports of Examinations of Government Securities Activities" • SR-94-5, "Government Securities Act Amendments of 1993" • SR-93-40, "Department of the Treasury Interpretation Regarding Allocation of Securities to Customer Accounts in Hold-in-Custody Repurchase Transactions" • SR-90-1, "Examination of State Branches and Agencies of Foreign Banks for Compliance with Regulations Related to Government Securities Activities" • SR-88-26, "Examination Procedures Relating To Government Securities Activities" • SR-87-37, "Examination Procedures Relating to Government Securities Activities" • SR-86-40, "Revised Municipal Securities Dealer Examination Procedures and Report Forms"
Consumer Examinations	• Federal Reserve's *Consumer Compliance Handbook*

This section sets forth the principal aspects of effective internal control and audit and discusses some pertinent points relative to the internal control questionnaires (ICQs). It assists the examiner in understanding and evaluating the objectives of and the work performed by internal and external auditors. It also sets forth the general criteria the examiner should consider to determine if the work of internal and external auditors can be relied on in the performance of the examination. To the extent that audit records can be relied on, they should be used to complete the ICQs implemented during the examination. In most cases, only those questions not fully supported by audit records would require the examiner to perform a detailed review of the area in question.

Effective internal control is a foundation for the safe and sound operation of a financial institution. The board of directors and senior managers of an institution are responsible for ensuring that the system of internal control is effective. Their responsibility *cannot* be delegated to others within or outside the organization. An internal audit function is an important element of an effective system of internal control. When properly structured and conducted, internal audit provides directors and senior management with vital information about the condition of the system of internal control, and it identifies weaknesses so that management can take prompt, remedial action. Examiners are to review an institution's internal audit function and recommend improvements if needed. In addition, under the Interagency Guidelines Establishing Standards for Safety and Soundness,[1] pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act) (12 USC 1831p-1), each institution is required to have an internal audit function that is appropriate to its size and the nature and scope of its activities.

In summary, internal control is a process designed to provide reasonable assurance that the institution will achieve the following objectives: efficient and effective operations, including safeguarding of assets; reliable financial reporting; and compliance with applicable laws and regulations. Internal control consists of five components that are a part of the management process: control environment, risk assessment, control activities, information and communication, and monitoring activities. The effective functioning of these components, which is brought about by an institution's board of directors, management, and other personnel, is essential to achieving the internal control objectives. This description of internal control is consistent with the Committee of Sponsoring Organizations of the Treadway Commission (COSO) report *Internal Control—Integrated Framework*. In addition, under the COSO framework, financial reporting is defined in terms of published financial statements, which, for these purposes, encompass financial statements prepared in accordance with generally accepted accounting principles and regulatory reports (such as the Reports of Condition and Income). Institutions are encouraged to evaluate their internal control against the COSO framework.

This section includes the March 17, 2003, ''Interagency Policy Statement on the Internal Audit Function and Its Outsourcing.'' In addition, that policy statement is immediately followed by a January 23, 2013, ''Federal Reserve Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing,'' which supplements the 2003 guidance.

AUDIT COMMITTEE OVERSIGHT

Internal and external auditors will not feel free to assess the bank's operations if their independence is compromised. This can sometimes happen when internal and external auditors report solely to senior management instead of to the board of directors.

The independence of internal and external auditors is increased when they report to an independent audit committee (one made up of external directors who are not members of the bank's management). The auditors' independence is enhanced when the audit committee takes an active role in approving the internal and external audit scope and plan.

The role of the independent audit committee is important. The audit committee's duties may include (1) overseeing the internal audit function; (2) approving or recommending the appointment of external auditors and the scope

1. For state member banks, see appendix D-1 to 12 CFR 208.

of external audits and other services; (3) providing the opportunity for auditors to meet and discuss findings apart from management; (4) reviewing with management and external auditors the year-end financial statements; and (5) meeting with regulatory authorities.

Public Company Accounting Oversight Board

The Sarbanes-Oxley Act of 2002 (the act) became law on July 30, 2002 (Pub. L. No. 107-204). The act addresses weaknesses in corporate governance and the accounting and auditing professions and includes provisions addressing audits, financial reporting and disclosure, conflicts of interest, and corporate governance at publicly owned companies. The act, among other things, requires public companies to have an audit committee made entirely of independent directors. Publicly owned banking organizations that are listed on the New York Stock Exchange (NYSE) and Nasdaq must also comply with those exchanges' listing requirements, which include audit committee requirements.

The act also established a Public Company Accounting Oversight Board (PCAOB) that has the authority to set and enforce auditing, attestation, quality-control, and ethics (including independence) standards for auditors of public companies (subject to Securities and Exchange Commission (SEC) review). (See SR-02-20.) Accounting firms that conduct audits of public companies (registered accounting firms) must register with the PCAOB and be subject to its supervision. The PCAOB is also empowered to inspect the auditing operations of public accounting firms that audit public companies as well as impose disciplinary and remedial sanctions for violations of its rules, securities laws, and professional auditing and accounting standards. (See www.pcaobus.org.)

Nonpublic banking organizations are encouraged to periodically review their policies and procedures relating to corporate-governance and auditing matters. This review should ensure that such policies and procedures are consistent with applicable law, regulations, and supervisory guidance and remain appropriate in light of the organization's size, operations, and resources. Furthermore, a banking organization's policies and procedures for corporate governance, internal controls, and auditing will be assessed during the supervisory process, and supervisory action may be taken if there are deficiencies or weaknesses in these areas that are inconsistent with sound corporate-governance practices or safety-and-soundness considerations.

DISCIPLINARY ACTIONS AGAINST ACCOUNTANTS AND ACCOUNTING FIRMS PERFORMING CERTAIN AUDIT SERVICES

Section 36 of the Federal Deposit Insurance Act (the FDI Act) authorizes the federal bank and thrift regulatory agencies (the agencies)[3] to take disciplinary actions against independent public accountants and accounting firms that perform audit services covered by the act's provisions. Section 36, as implemented by part 363 of the FDIC's rules (12 CFR 363), requires that each federally insured depository institution with total assets of $500 million or more obtain an audit of its financial statements and a management report. Institutions with assets of $1 billion or more must provide an attestation on management's assertions concerning internal controls over financial reporting that is performed by an independent public accountant (the accountant). The respective insured depository institution must include the accountant's audit and attestation reports in its annual report, as required. See the section on "Legal Requirements Affecting Banks and the Audit Function."

The agencies amended their rules, pursuant to section 36, that set forth the practices and procedures to implement their authority to remove, suspend, or debar, for good cause,[3a] an accountant or firm from performing audit and attestation services for insured depository institutions with assets of $500 million or more.[3b] Immediate suspensions are permitted in limited circum-

3. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. The Board approved its rules on August 6, 2003 (press release of August 8, 2003). The rules became effective October 1, 2003. They were later revised as of July 20, 2009.

3a. The rules provide that certain violations of law, negligent conduct, reckless violations of professional standards, or lack of qualifications to perform auditing services may be considered good cause.

3b. See the Federal Reserve's rules on disciplinary actions against public accountants and accounting firms at 12 CFR 263.94 and 12 CFR 263, subpart J.

stances. Also, an accountant or accounting firm is prohibited from performing audit services for the covered institution if an authorized agency has taken such a disciplinary action against the accountant or firm, or if the SEC or the PCAOB has taken certain disciplinary action against the accountant or firm.

The amended rules reflect the agencies' increasing concern about the quality of audits and internal controls for financial reporting at insured depository institutions. The rules emphasize the importance of maintaining high quality in the audits of federally insured depository institutions' financial position and in the attestations of management assessments.

OBJECTIVES OF INTERNAL CONTROL

In general, good internal control exists when no one is in a position to make significant errors or perpetrate significant irregularities without timely detection. Therefore, a system of internal control should include those procedures necessary to ensure timely detection of failure of accountability, and such procedures should be performed by competent persons who have no incompatible duties. The following standards are encompassed within the description of internal control:

Existence of procedures. Existence of prescribed internal control procedures is necessary but not sufficient for effective internal control. Prescribed procedures that are not actually performed do nothing to establish control. Consequently, the examiner must give thoughtful attention not only to the prescribed set of procedures but also to the practices actually followed. This attention can be accomplished through inquiry, observation, testing, or a combination thereof.

Competent performance. For internal control to be effective, the required procedures must be performed by competent persons. Evaluation of competence undoubtedly requires some degree of subjective judgment because attributes such as intelligence, knowledge, and attitude are relevant. Thus, the examiner should be alert for indications that employees have failed so substantially to perform their duties that a serious question is raised concerning their abilities.

Independent performance. If employees who have access to assets also have access to the related accounting records or perform related review operations (or immediately supervise the activities of other employees who maintain the records or perform the review operations), they may be able to both perpetrate and conceal defalcations. Therefore, duties concerned with the custody of assets are incompatible with recordkeeping duties for those assets, and duties concerned with the performance of activities are incompatible with the authorization or review of those activities.

In judging the independence of a person, the examiner must avoid looking at that person as an individual and presuming the way in which that individual would respond in a given situation. For example, an individual may be the sole check signer and an assistant may prepare monthly bank reconcilement. If the assistant appears to be a competent person, it may seem that an independent reconcilement would be performed and anything amiss would be reported. Such judgments are potentially erroneous. There exist no established tests by which the psychological and economic independence of an individual in a given situation can be judged. The position must be evaluated, not the person. If the position in which the person acts is not an independent one in itself, then the work should not be presumed to be independent, regardless of the apparent competence of the person in question. In the example cited above, the function performed by the assistant should be viewed as if it were performed by the supervisor. Hence, incompatible duties are present in that situation.

PROCEDURES FOR COMPLETING ICQs

The implementation of selected ICQs and the evaluation of internal audit activities provide a basis for determining the adequacy of the bank's control environment. To reach conclusions required by the questionnaires, the examiner assigned to review a given internal control routine or area of bank operations should use any source of information necessary to ensure a full understanding of the prescribed system, including any potential weaknesses. Only when the examiner completely understands the bank's system can an assessment and evaluation be made of the effects of internal controls on the examination.

To reach conclusions concerning a specific section of an ICQ, the examiner should document and review the bank's operating systems and procedures by consulting all available sources of information and discussing them with appropriate bank personnel. Sources of information might include organization charts, procedural manuals, operating instructions, job specifications, directives to employees, and other similar sources of information. Also, the examiner should not overlook potential sources such as job descriptions, flow charts, and other documentation in the internal audit workpapers. A primary objective in the review of the system is to efficiently reach a conclusion about the overall adequacy of existing controls. Any existing source of information that will enable the examiner to quickly gain an understanding of the procedures in effect should be used in order to minimize the time required to formulate the conclusions. The review should be documented in an organized manner through the use of narrative descriptions, flow charts, or other diagrams. If a system is properly documented, the documentation will provide a ready reference for any examiner performing work in the area, and it often may be carried forward for future examinations, which will save time.

Although narrative descriptions can often provide an adequate explanation of systems of internal control, especially in less complex situations, they may have certain drawbacks, such as the following:

- They may be cumbersome and too lengthy.
- They may be unclear or poorly written.
- Related points may be difficult to integrate.
- Annual changes may be awkward to record.

To overcome these problems, the examiner should consider using flow charts, which reduce narrative descriptions to a picture. Flow charts often reduce a complex situation to an easily understandable sequence of interrelated steps.

In obtaining and substantiating the answers to the questions in the ICQ, the examiner should develop a plan to obtain the necessary information efficiently. Such a plan would normally avoid a direct question-and-answer session with bank officers. A suggested approach to completion of the ICQ is to—

- become familiar with the ICQ,
- review related internal audit procedures, reports, and responses,
- review any written documentation of a bank's system of controls,
- find out what the department does and what the functions of personnel within the department are through conversations with appropriate individuals, and
- answer as many individual questions as possible from information gained in the preceding steps and fill in the remaining questions by direct inquiry.

An effective way to begin an on-site review of internal control is to identify the various key functions applicable to the area under review. For each position identified, the following questions should then be asked:

- Is this a critical position? That is, can a person in this position either make a significant error that will affect the recording of transactions or perpetrate material irregularities of some type?
- If an error is made or an irregularity is perpetrated, what is the probability that normal routines will disclose it on a timely basis? That is, what controls exist that would prevent or detect significant errors or the perpetration of significant irregularities?
- What are the specific opportunities open to the individual to conceal any irregularity, and are there any mitigating controls that will reduce or eliminate these opportunities?

Although all employees within an organization may be subject to control, not all have financial responsibilities that can influence the accuracy of the accounting and financial records or have access to assets. The examiner should be primarily concerned with those positions that have the ability to influence the records and that have access to assets. Once those positions have been identified, the examiners must exercise their professional knowledge of bank operations to visualize the possibilities open to any person holding a particular position. The question is not whether the individual is honest, but rather whether situations exist that might permit an error to be concealed. By directing attention to such situations, an examiner will also consider situations that may permit unintentional errors to remain undetected.

The evaluation of internal control should include consideration of other existing accounting and administrative controls or other circumstances that might counteract or mitigate an apparent weakness or impair an established control. Controls that mitigate an apparent weakness may be a formal part of the bank's operating system, such as budget procedures that include a careful comparison of budgeted and actual amounts by competent management personnel. Mitigating controls also may be informal. For example, in small banks, management may be sufficiently involved in daily operations to know the purpose and reasonableness of all expense disbursements. That knowledge, coupled with the responsibility for signing checks, may make irregularities by nonmanagement personnel unlikely, even if disbursements are otherwise under the control of only one person.

When reviewing internal controls, an essential part of the examination is being alert to indications that adverse circumstances may exist. Adverse circumstances may lead employees or officers into courses of action they normally would not pursue. An adverse circumstance to which the examiner should be especially alert exists when the personal financial interests of key officers or employees depend directly on operating results or financial condition. Although the review of internal control does not place the examiner in the role of an investigator or detective, an alert attitude toward possible conflicts of interest should be maintained throughout the examination. Also, offices staffed by members of the same family, branches completely dominated by a strong personality, or departments in which supervisors rely unduly on their assis-tants require special alertness on the part of the examiner. Those circumstances and other similar ones should be considered in preparing the ICQ. It is not the formality of the particular factor that is of importance but rather its effect on the overall operation under review. Circumstances that may affect answers to the basic questions should be noted along with conclusions concerning their effect on the examination.

The ICQs were designed so that answers could be substantiated by (1) inquiry to bank personnel, (2) observation, or (3) testing. However, certain questions are marked with an asterisk to indicate that they require substantiation through observation or testing. Those questions are deemed so critical that substantiation by inquiry is not sufficient. For those questions substantiated through testing, the nature and extent of the test performed should be indicated adjacent to the applicable step in the ICQ.

The examiner should be alert for deviations by bank personnel from established policies, practices, and procedures. This applies not only to questions marked with an asterisk but also to every question in the ICQ. Examples of such deviations include situations when (1) instructions and directives are frequently not revised to reflect current practices, (2) employees find shortcuts for performing their tasks, (3) changes in organization and activities may influence operating procedures in unexpected ways, or (4) employees' duties may be rotated in ways that have not been previously considered. These and other circumstances may serve to modify or otherwise change prescribed procedures, thus giving the examiner an inadequate basis for evaluating internal control.

Sometimes, when a substantial portion of the accounting work is accomplished by computer, the procedures are so different from conventional accounting methods that the principles discussed here seem inapplicable. Care should be taken to resist drawing this conclusion. This discussion of internal control and its evaluation is purposely stated in terms sufficiently general to apply to any system. Perpetration of defalcations requires direct or indirect access to appropriate documents or accounting records. As such, perpetration requires the involvement of people and, under any system, computerized or not, there will be persons who have access to assets and records. Those with access may include computer operators, programmers, and their supervisors and other related personnel.

The final question in each section of the ICQ requires a composite evaluation of existing internal controls in the applicable area of the bank. The examiner should base that evaluation on answers to the preceding questions within the section, the review and observation of the systems and controls within the bank, and discussion with appropriate bank personnel.

The composite evaluation does, however, require some degree of subjective judgment. The examiner should use all information available to formulate an overall evaluation, fully realizing that a high degree of professional judgment is required.

Applying the ICQ to Different Situations

The ICQs are general enough to apply to a wide range of systems, so not all sections or questions will apply to every situation, depending on factors such as bank size, complexity and type of operations, and organizational structure. When completing the ICQs, the examiner should include a brief comment stating the reason a section or question is not applicable to the specific situation.

For large banking institutions or when multiple locations of a bank are being examined, it may be necessary to design supplements to the ICQs to adequately review all phases of the bank's operations and related internal controls. Because certain functions described in this manual may be performed by several departments in some banks, it also may be necessary to redesign a particular section of the ICQ so that each department receives appropriate consideration. Conversely, functions described in several different sections of this handbook may be performed in a single department in smaller banks. If the ICQ is adapted to fit a specific situation, care should be taken to ensure that its scope and intent are not modified. That requires professional judgment in interpreting and expanding the generalized material. Any such modifications should be completely documented and filed in the workpapers.

LEGAL REQUIREMENTS AFFECTING BANKS AND THE AUDIT FUNCTION

The Federal Deposit Insurance Corporation Improvement Act of 1991 amended section 36 of the FDI Act (12 USC 1831m). Since then, the FDIC has made various revisions to its rules at Part 363 (12 CFR 363) and guidelines. When specific reports are required to be submitted to the FDIC to comply with the provisions of compliance with Part 363, the institution must also submit the report to the appropriate federal banking agency and any appropriate state supervisor.

For the purposes of determining the applicability of this rule, an institution should use total assets as reported on its most recent Report of Condition (the Call Report), the date that coincides with the end of the preceding fiscal year. If the fiscal year ends on a date other than the end of a calendar quarter, the institution is to use the Call Report for the quarter end immediately preceding the end of the fiscal year.

Institutions with $500 Million or More in Total Assets

The regulations require these institutions to file two copies of their annual reports with the FDIC, as well as with the appropriate federal banking agency and the appropriate state supervisory agency, that must include the following:

- Audited comparative annual financial statements;
- The independent public accountant's report on the audited financial statements;
- A management report (comprising its statements and assessments) that is signed by the chief executive officer and chief accounting or chief financial officer. The report should include:
  - — A statement of management's responsibilities for:
    - preparing the annual financial statements;
    - establishing and maintaining an adequate internal control structure and procedures over financial reporting;
    - complying with designated safety-and-soundness laws and regulations pertaining to insider loans and dividend restrictions; and
  - — An assessment by management of:
    - compliance with the designated safety-and-soundness laws and regulations pertaining to insider loans and dividend restrictions during the year, which must state management's conclusions regarding compliance and disclose any noncompliance with these laws and regulations.[3c] (See SR-13-11.)

If the institution is a public company or a subsidiary of a public company that would be subject to the provisions of section 404 of the Sarbanes-Oxley Act (Section 404), it must comply with the requirement to file other reports issued by the independent accountant as set forth in section 363.4(c) (12 CFR 363.4(c)). The institutions must provide a copy of the independent accountant's report to the FDIC on the audit of internal control over financial reporting that is required by section 404 with the FDIC within 15 days after receipt. The institutions also are

3c. See appendix B of 12 CFR part 363 for further details and illustrative examples of the appropriate wording for the management report.

encouraged to submit a copy of management's section 404 report on internal control over financial reporting together with the independent public accountant's internal control report.

Institutions with $1 Billion or More in Total Assets

Section 36 of the FDI Act and Part 363 of the FDIC's regulations required insured depository institutions with a least $1 billion in total assets to file two copies of additional reports that must include the following:

- Assessments by management of the effectiveness of the institution's internal control structure and procedures over financial reporting as of the end of the fiscal year (12 USC 1831m(b)(2)(B)(i); and
- The independent public accountant's attestation report—the independent public accountant is to examine, attest to, and report separately in an attestation report, on the assertions by management's concerning the institution's internal control structure and procedures for financial reporting (12 USC 1831m(c)). This includes the Call Report and the FR Y-9C report. The attestation is to be made in accordance with generally accepted standards for attestation engagements.

Other Requirements—Institutions with $500 Million or More in Total Assets

Financial reporting encompasses, for the purposes of Part 363, both financial statements prepared in accordance with generally accepted accounting principles and those prepared for regulatory reporting purposes. Each institution is to have an independent public accountant perform an audit who reports on the institution's annual financial statements in accordance with generally accepted auditing standards and section 37 of the FDI Act (12 USC 1831n). The scope of the audit engagement must be sufficient to permit the accountant to determine and report whether the financial statements are presented fairly and in accordance with generally accepted accounting principles. The audit is to be performed using procedures that will objectively determine the accuracy of management's assertions on compliance with safety-and-soundness laws and regulations (12 USC 1831m (b)(2)(A)(iii)).

In addition, each institution is required to file a copy of any management letter, qualification, or any other report issued by its independent public accountant with the FDIC within 15 days of receipt of such letter or report. See section 363.4(c) (12 CFR 363.4(c)).

Each institution is required to establish an audit committee of its board of directors. The duties of the audit committee include reviewing with management and the independent public accountant the basis for, and the results of, the annual independent audit reports and the institution's respective reporting requirements. Each institution with total assets of $1 billion or more, as of the beginning of the fiscal year, is required to have an audit committee, the members of which must be outside directors who are independent of the institution's management. Institutions with total assets of $500 million, but less than $1 billion or more, as of the beginning of the fiscal year, must have an audit committee, the members of which are outside directors, the majority of whom must be independent of the institution's management.

Reporting Requirements for Subsidiaries of Holding Companies

Under the FDIC rules, an insured depository institution that is a subsidiary of a holding company may file its audited financial statements at the holding company level (top-tier or mid-tier) if the holding company has total insured depository institution assets comprising 75 percent or more of the holding company's consolidated assets as of the beginning of the fiscal year. Furthermore, in accordance with 12 CFR part 363, the other reporting requirements can be satisfied at the holding company level if the holding company provides services and functions comparable to the insured depository institution, and the insured depository subsidiary (a) has less than $5 billion in total assets or (b) has a CAMELS composite rating of "1" or "2" when its total assets are $5 billion or more.

In order to facilitate effective and prudential supervision of the holding company, a holding company that has institutions subject to the FDIC rules must submit one copy of the required reports to the appropriate Federal Reserve Bank regardless of whether or not the holding company submitted these reports on a consolidated basis for its insured depository subsidiaries, and regardless of the charter of the insured depository subsidiary under the holding company. Refer to SR letter 94-3, ‘‘Supervisory Guidance on the Implementation of Section 112 of the FDIC Improvement Act,’’ for further guidance on this filing requirement. (See SR-13-11.)

Required Management Report Signatures

As specified in 12 CFR part 363, an insured depository institution and holding company must adhere to the following signature requirements:

- If the audited financial statements and the management report requirements are satisfied entirely at the insured depository institution level, the management report must be signed by the CEO, as well as the CAO or CFO, at the insured depository institution level.
- If the audited financial statements and the management report requirements are satisfied entirely at the holding company level, the management report must be signed by the CEO, as well as the CAO or CFO, at the holding company level.
- If the audited financial statement requirements are satisfied at the holding company level and the management report requirement is satisfied at the insured depository institution level or one or more component requirements are satisfied at the holding company and the remaining component requirements are satisfied at the insured depository institution level, the management report must be signed by the CEO, as well as the CAO or CFO, of both the holding company and the insured depository institution.

INTERAGENCY POLICY STATEMENT ON THE INTERNAL AUDIT FUNCTION AND ITS OUTSOURCING

The Federal Reserve and other federal banking agencies[3d] (the agencies) adopted on March 17, 2003, an interagency policy statement addressing the internal audit function and its outsourcing. The policy statement revises and replaces the former 1997 policy statement and incorporates recent developments in internal auditing. In addition, the revised policy incorporates guidance on the independence of accountants who provide institutions with both internal and external audit services in light of the Sarbanes-Oxley Act of 2002 (the act) and associated SEC rules.

The act prohibits an accounting firm from acting as the external auditor of a public company during the same period that the firm provides internal audit services to the company. The policy statement discusses the applicability of this prohibition to institutions that are public companies, to insured depository institutions with assets of $500 million or more that are subject to the annual audit and reporting requirements of section 36 of the FDI Act, and to nonpublic institutions that are not subject to section 36.

The statement recognizes that many institutions have engaged independent public accounting firms and other outside professionals (outsourcing vendors) to perform work that traditionally has been done by internal auditors. These arrangements are often called ‘‘internal audit outsourcing,’’ ‘‘internal audit assistance,’’ ‘‘audit co-sourcing,’’ and ‘‘extended audit services’’ (hereafter collectively referred to as outsourcing). Typical outsourcing arrangements are more fully described below.

Outsourcing may be beneficial to an institution if it is properly structured, carefully conducted, and prudently managed. However, the structure, scope, and management of some internal audit outsourcing arrangements may not contribute to the institution’s safety and soundness. Furthermore, arrangements with outsourcing vendors should not leave directors and senior management with the erroneous impression that they have been relieved of their responsibility for maintaining an effective system of internal control and for overseeing the internal audit function.

Internal Audit Function (Part I)

Board and Senior Management Responsibilities

The board of directors and senior management

3d. The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency.

are responsible for having an effective system of internal control and an effective internal audit function in place at their institution. They are also responsible for ensuring that the importance of internal control is understood and respected throughout the institution. This overall responsibility cannot be delegated to anyone else. They may, however, delegate the design, implementation, and monitoring of specific internal controls to lower-level management and delegate the testing and assessment of internal controls to others. Accordingly, directors and senior management should have reasonable assurance that the system of internal control prevents or detects significant inaccurate, incomplete, or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial reporting (which includes regulatory reporting); and deviations from laws, regulations, and the institution's policies.[4]

Some institutions have chosen to rely on so-called management self-assessments or control self-assessments, wherein business-line managers and their staff evaluate the performance of internal controls within their purview. Such reviews help to underscore management's responsibility for internal control, but they are not impartial. Directors and members of senior management who rely too much on these reviews may not learn of control weaknesses until they have become costly problems, particularly if directors are not intimately familiar with the institution's operations. Therefore, institutions generally should also have their internal controls tested and evaluated by units without business-line responsibilities, such as internal audit groups.

Directors should be confident that the internal audit function addresses the risks of and meets the demands posed by the institution's current and planned activities. To accomplish this objective, directors should consider whether their institution's internal audit activities are conducted in accordance with professional standards, such as the Institute of Internal Auditors' (IIA) *Standards for the Professional Practice of Internal Auditing.* These standards address independence, professional proficiency, scope of work, performance of audit work, management of internal audit, and quality-assurance reviews. Furthermore, directors and senior management should ensure that the following matters are reflected in their institution's internal audit function.

Structure. Careful thought should be given to the placement of the audit function in the institution's management structure. The internal audit function should be positioned so that the board has confidence that the internal audit function will perform its duties with impartiality and not be unduly influenced by managers of day-to-day operations. The audit committee,[5] using objective criteria it has established, should oversee the internal audit function and evaluate its performance.[6] The audit committee should assign responsibility for the internal audit function to a member of management (that is, the manager of internal audit or internal audit manager) who understands the function and has no responsibility for operating the system of internal control. The ideal organizational arrangement is for this manager to report directly and solely to the audit committee regarding both audit issues and administrative matters, for example, resources, budget, appraisals, and compensation. Institutions are encouraged to consider the IIA's *Practice Advisory 2060-2: Relation-*

4. As noted above, under section 36 of the FDI Act, as implemented by part 363 of the FDIC's regulations (12 CFR 363), FDIC-insured depository institutions with total assets of $500 million or more must submit an annual management report signed by the chief executive officer (CEO) and chief accounting or chief financial officer. This report must contain (1) a statement of management's responsibilities for preparing the institution's annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with designated laws and regulations relating to safety and soundness, including management's assessment of the institution's compliance with those laws and regulations, and (2) for an institution with total assets of $1 billion or more at the beginning of the institution's most recent fiscal year, an assessment by management of the effectiveness of such internal control structure and procedures as of the end of such fiscal year. (See 12 CFR 363.2(b) and 70 *Fed. Reg.* 71,232, Nov. 28, 2005.)

5. Depository institutions subject to section 36 of the FDI Act and part 363 of the FDIC's regulations must maintain independent audit committees (i.e., consisting of directors who are not members of management). Consistent with the 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations, the agencies also encourage the board of directors of each depository institution that is not otherwise required to do so to establish an audit committee consisting entirely of outside directors. Where the term *audit committee* is used in this policy statement, the board of directors may fulfill the audit committee responsibilities if the institution is not subject to an audit committee requirement. See *Fed. Reg.,* September 28, 1999 (64 FR 52,319).

6. For example, the performance criteria could include the timeliness of each completed audit, a comparison of overall performance to plan, and other measures.

ship with the Audit Committee, which provides more guidance on the roles and relationships between the audit committee and the internal audit manager.

Many institutions place the manager of internal audit under a dual reporting arrangement: the manager is functionally accountable to the audit committee on issues discovered by the internal audit function, while reporting to another senior manager on administrative matters. Under a dual reporting relationship, the board should consider the potential for diminished objectivity on the part of the internal audit manager with respect to audits concerning the executive to whom he or she reports. For example, a manager of internal audit who reports to the chief financial officer (CFO) for performance appraisal, salary, and approval of department budgets may approach audits of the accounting and treasury operations controlled by the CFO with less objectivity than if the manager were to report to the chief executive officer. Thus, the chief financial officer, controller, or other similar officer should ideally be excluded from overseeing the internal audit activities even in a dual role. The objectivity and organizational stature of the internal audit function are best served under such a dual arrangement if the internal audit manager reports administratively to the CEO.

Some institutions seek to coordinate the internal audit function with several risk-monitoring functions (for example, loan-review, market-risk-assessment, and legal compliance departments) by establishing an administrative arrangement under one senior executive. Coordination of these other monitoring activities with the internal audit function can facilitate the reporting of material risk and control issues to the audit committee, increase the overall effectiveness of these monitoring functions, better utilize available resources, and enhance the institution's ability to comprehensively manage risk. Such an administrative reporting relationship should be designed so as to not interfere with or hinder the manager of internal audit's functional reporting to and ability to directly communicate with the institution's audit committee. In addition, the audit committee should ensure that efforts to coordinate these monitoring functions do not result in the manager of internal audit conducting control activities nor diminish his or her independence with respect to the other risk-monitoring functions. Furthermore, the internal audit manager should have the ability to independently audit these other monitoring functions.

In structuring the reporting hierarchy, the board should weigh the risk of diminished independence against the benefit of reduced administrative burden in adopting a dual reporting organizational structure. The audit committee should document its consideration of this risk and mitigating controls. The IIA's *Practice Advisory 1110-2: Chief Audit Executive Reporting Lines* provides additional guidance regarding functional and administrative reporting lines.

Management, staffing, and audit quality. In managing the internal audit function, the manager of internal audit is responsible for control risk assessments, audit plans, audit programs, and audit reports.

- A control risk assessment (or risk-assessment methodology) documents the internal auditor's understanding of the institution's significant business activities and their associated risks. These assessments typically analyze the risks inherent in a given business line, the mitigating control processes, and the resulting residual risk exposure of the institution. They should be updated regularly to reflect changes to the system of internal control or work processes and to incorporate new lines of business.
- An internal audit plan is based on the control risk assessment and typically includes a summary of key internal controls within each significant business activity, the timing and frequency of planned internal audit work, and a resource budget.
- An internal audit program describes the objectives of the audit work and lists the procedures that will be performed during each internal audit review.
- An audit report generally presents the purpose, scope, and results of the audit, including findings, conclusions, and recommendations. Workpapers that document the work performed and support the audit report should be maintained.

Ideally, the internal audit function's only role should be to independently and objectively evaluate and report on the effectiveness of an institution's risk-management, control, and governance processes. Internal auditors increasingly have taken a consulting role within institutions on new products and services and on mergers, acquisitions, and other corporate reorganizations. This role typically includes helping design controls and participating in the implementation of changes to the institution's control activities. The audit committee, in its oversight of the internal audit staff, should ensure that the function's consulting activities do not interfere or conflict with the objectivity it should have with respect to monitoring the institution's system of internal control. In order to maintain its independence, the internal audit function should not assume a business-line management role over control activities, such as approving or implementing operating policies or procedures, including those it has helped design in connection with its consulting activities. The agencies encourage internal auditors to follow the IIA's standards, including guidance related to the internal audit function acting in an advisory capacity.

The internal audit function should be competently supervised and staffed by people with sufficient expertise and resources to identify the risks inherent in the institution's operations and assess whether internal controls are effective. The manager of internal audit should oversee the staff assigned to perform the internal audit work and should establish policies and procedures to guide the audit staff. The form and content of these policies and procedures should be consistent with the size and complexity of the department and the institution. Many policies and procedures may be communicated informally in small internal audit departments, while larger departments would normally require more formal and comprehensive written guidance.

Scope. The frequency and extent of internal audit review and testing should be consistent with the nature, complexity, and risk of the institution's on- and off-balance-sheet activities. At least annually, the audit committee should review and approve internal audit's control risk assessment and the scope of the audit plan, including how much the manager relies on the work of an outsourcing vendor. It should also periodically review internal audit's adherence to the audit plan. The audit committee should consider requests for expansion of basic internal audit work when significant issues arise or when significant changes occur in the institution's environment, structure, activities, risk exposures, or systems.[7]

Communication. To properly carry out their responsibility for internal control, directors and senior management should foster forthright communications and critical examination of issues to better understand the importance and severity of internal control weaknesses identified by the internal auditor and operating management's solutions to these weaknesses. Internal auditors should report internal control deficiencies to the appropriate level of management as soon as they are identified. Significant matters should be promptly reported directly to the board of directors (or its audit committee) and senior management. In periodic meetings with management and the manager of internal audit, the audit committee should assess whether management is expeditiously resolving internal control weaknesses and other exceptions. Moreover, the audit committee should give the manager of internal audit the opportunity to discuss his or her findings without management being present.

Furthermore, each audit committee should establish and maintain procedures for employees of their institution to confidentially and anonymously submit concerns to the committee about questionable accounting, internal accounting control, or auditing matters.[8] In addition, the audit committee should set up procedures for the timely investigation of complaints received and the retention for a reasonable time period of documentation concerning the complaint and its subsequent resolution.

Contingency planning. As with any other function, the institution should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high-risk areas. Lack of contingency planning for continuing internal audit coverage may increase the institution's level of operational risk.

Small Financial Institution's Internal Audit Function

An effective system of internal control and an independent internal audit function form the foundation for safe and sound operations, regardless of an institution's size. Each institution should have an internal audit function that is appropriate to its size and the nature and scope of its activities. The procedures assigned to this function should include adequate testing

7. Major changes in an institution's environment and conditions may compel changes to the internal control system and also warrant additional internal audit work. These changes include (1) new management; (2) areas or activities experiencing rapid growth or rapid decline; (3) new lines of business, products, or technologies or disposals thereof; (4) corporate restructurings, mergers, and acquisitions; and (5) an expansion or acquisition of foreign operations (including the impact of changes in the related economic and regulatory environments).

8. When the board of directors fulfills the audit committee responsibilities, the procedures should provide for the submission of employee concerns to an outside director.

and review of internal controls and information systems.

It is the responsibility of the audit committee and management to carefully consider the extent of auditing that will effectively monitor the internal control system, after taking into account the internal audit function's costs and benefits. For institutions that are large or have complex operations, the benefits derived from a full-time manager of internal audit or an auditing staff likely outweigh the cost. For small institutions with few employees and less complex operations, however, these costs may outweigh the benefits. Nevertheless, a small institution without an internal auditor can ensure that it maintains an objective internal audit function by implementing a comprehensive set of independent reviews of significant internal controls. The key characteristic of such reviews is that the persons directing and/or performing the review of internal controls are *not* also responsible for managing or operating those controls. A person who is competent in evaluating a system of internal control should design the review procedures and arrange for their implementation. The person responsible for reviewing the system of internal control should report findings directly to the audit committee. The audit committee should evaluate the findings and ensure that senior management has or will take appropriate action to correct the control deficiencies.

Internal Audit Outsourcing Arrangements (Part II)

Examples of Internal Audit Outsourcing Arrangements

An outsourcing arrangement is a contract between an institution and an outsourcing vendor to provide internal audit services. Outsourcing arrangements take many forms and are used by institutions of all sizes. Some institutions consider entering into these arrangements to enhance the quality of their control environment by obtaining the services of a vendor with the knowledge and skills to critically assess, and recommend improvements to, their internal control systems. The internal audit services under contract can be limited to helping internal audit staff in an assignment for which they lack expertise. Such an arrangement is typically under the control of the institution's manager of internal audit, and the outsourcing vendor reports to him or her. Institutions often use outsourcing vendors for audits of areas requiring more technical expertise, such as electronic data processing and capital-markets activities. Such uses are often referred to as "internal audit assistance" or "audit co-sourcing."

Some outsourcing arrangements may require an outsourcing vendor to perform virtually all the procedures or tests of the system of internal control. Under such an arrangement, a designated manager of internal audit oversees the activities of the outsourcing vendor and typically is supported by internal audit staff. The outsourcing vendor may assist the audit staff in determining risks to be reviewed and may recommend testing procedures, but the internal audit manager is responsible for approving the audit scope, plan, and procedures to be performed. Furthermore, the internal audit manager is responsible for the results of the outsourced audit work, including findings, conclusions, and recommendations. The outsourcing vendor may report these results jointly with the internal audit manager to the audit committee.

Additional Considerations for Internal Audit Outsourcing Arrangements

Even when outsourcing vendors provide internal audit services, the board of directors and senior management of an institution are responsible for ensuring that both the system of internal control and the internal audit function operate effectively. In any outsourced internal audit arrangement, the institution's board of directors and senior management must maintain ownership of the internal audit function and provide active oversight of outsourced activities. When negotiating the outsourcing arrangement with an outsourcing vendor, an institution should carefully consider its current and anticipated business risks in setting each party's internal audit responsibilities. The outsourcing arrangement should not increase the risk that a breakdown of internal control will go undetected.

To clearly distinguish its duties from those of the outsourcing vendor, the institution should have a written contract, often taking the form of an engagement letter.[9] Contracts between the

9. The engagement-letter provisions described are comparable to those outlined by the American Institute of Certified Public Accountants (AICPA) for financial statement audits.

institution and the vendor typically include provisions that—

- define the expectations and responsibilities under the contract for both parties;
- set the scope and frequency of, and the fees to be paid for, the work to be performed by the vendor;
- set the responsibilities for providing and receiving information, such as the type and frequency of reporting to senior management and directors about the status of contract work;
- establish the process for changing the terms of the service contract, especially for expansion of audit work if significant issues are found, and stipulations for default and termination of the contract;
- state that internal audit reports are the property of the institution, that the institution will be provided with any copies of the related workpapers it deems necessary, and that employees authorized by the institution will have reasonable and timely access to the workpapers prepared by the outsourcing vendor;
- specify the locations of internal audit reports and the related workpapers;
- specify the period of time (for example, seven years) that vendors must maintain the workpapers;[10]
- state that outsourced internal audit services provided by the vendor are subject to regulatory review and that examiners will be granted full and timely access to the internal audit reports and related workpapers prepared by the outsourcing vendor;
- prescribe a process (arbitration, mediation, or other means) for resolving disputes and for determining who bears the cost of consequential damages arising from errors, omissions, and negligence; and
- state that the outsourcing vendor will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of a member of management or an employee and, if applicable, will comply with AICPA, U.S. Securities and Exchange Commission (SEC), PCAOB, or regulatory independence guidance.

Vendor competence. Before entering an outsourcing arrangement, the institution should perform due diligence to satisfy itself that the outsourcing vendor has sufficient staff qualified to perform the contracted work. The staff's qualifications may be demonstrated, for example, through prior experience with financial institutions. Because the outsourcing arrangement is a personal-services contract, the institution's internal audit manager should have confidence in the competence of the staff assigned by the outsourcing vendor and receive timely notice of key staffing changes. Throughout the outsourcing arrangement, management should ensure that the outsourcing vendor maintains sufficient expertise to effectively perform its contractual obligations.

Management of the outsourced internal audit function. Directors and senior management should ensure that the outsourced internal audit function is competently managed. For example, larger institutions should employ sufficient competent staff members in the internal audit department to assist the manager of internal audit in overseeing the outsourcing vendor. Small institutions that do not employ a full-time audit manager should appoint a competent employee who ideally has no managerial responsibility for the areas being audited to oversee the outsourcing vendor's performance under the contract. This person should report directly to the audit committee for purposes of communicating internal audit issues.

Communication when an outsourced internal audit function exists. Communication between the internal audit function and the audit committee and senior management should not diminish because the institution engages an outsourcing vendor. All work by the outsourcing vendor should be well documented and all findings of control weaknesses should be promptly reported to the institution's manager of internal audit. Decisions not to report the outsourcing vendor's findings to directors and senior management should be the mutual decision of the internal audit manager and the outsourcing vendor. In deciding what issues should be brought to the board's attention, the

(See AICPA Professional Standards, AU section 310.) These provisions are consistent with the provisions customarily included in contracts for other outsourcing arrangements, such as those involving data processing and information technology. Therefore, the federal banking agencies consider these provisions to be usual and customary business practices.

10. If the workpapers are in electronic format, contracts often call for the vendor to maintain proprietary software that enables the bank and examiners to access the electronic workpapers for a specified time period.

concept of ‘‘materiality,’’ as the term is used in financial statement audits, is generally not a good indicator of which control weakness to report. For example, when evaluating an institution’s compliance with laws and regulations, any exception may be important.

Contingency planning to ensure continuity of outsourced audit coverage. When an institution enters into an outsourcing arrangement (or significantly changes the mix of internal and external resources used by internal audit), it may increase its operational risk. Because the arrangement may be terminated suddenly, the institution should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high-risk areas.

Independence of the Independent Public Accountant (Part III)

The following discussion applies only when a financial institution is considering using a public accountant to provide both external audit and internal audit services to the institution.

When one accounting firm performs both the external audit and the outsourced internal audit function, the firm risks compromising its independence. These concerns arise because, rather than having two separate functions, this outsourcing arrangement places the independent public accounting firm in the position of appearing to audit, or actually auditing, its own work. For example, in auditing an institution’s financial statements, the accounting firm will consider the extent to which it may rely on the internal control system, including the internal audit function, in designing audit procedures.

Applicability of the SEC’s Auditor Independence Requirements

Institutions that are public companies. To strengthen auditor independence, Congress passed the Sarbanes-Oxley Act of 2002 (the act). Title II of the act applies to any public company—that is, any company that has a class of securities registered with the SEC or the appropriate federal banking agency under section 12 of the Securities Exchange Act of 1934 or that is required to file reports with the SEC under section 15(d) of that act.[11] The act prohibits an accounting firm from acting as the external auditor of a public company during the same period that the firm provides internal audit outsourcing services to the company.[12] In addition, if a public company’s external auditor will be providing auditing services and permissible nonaudit services, such as tax services, the company’s audit committee must preapprove each of these services.

According to the SEC’s final rules (effective May 6, 2003) implementing the act’s nonaudit-service prohibitions and audit committee preapproval requirements, an accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides internal audit outsourcing or other prohibited nonaudit services to the public company audit client. The SEC’s final rules generally become effective on May 6, 2003, although there is a one-year transition period if the accountant is performing prohibited nonaudit services and external audit services for a public company pursuant to a contract in existence on May 6, 2003. The services provided during this transition period must not have impaired the auditor’s independence under the preexisting independence requirements of the SEC, the Independence Standards Board, and the AICPA. Although the SEC’s pre-Sarbanes-Oxley independence requirements (issued in November 2000, effective August 2002) did not prohibit the outsourcing of internal audit services to a public company’s independent public accoun-

11. 15 USC 78*l* and 78o(d).

12. In addition to prohibiting internal audit outsourcing, the Sarbanes-Oxley Act (15 USC 78j-1) also identifies other nonaudit services that an external auditor is prohibited from providing to a public company whose financial statements it audits. The legislative history of the act indicates that three broad principles should be considered when determining whether an auditor should be prohibited from providing a nonaudit service to an audit client. These principles are that an auditor should not (1) audit his or her own work, (2) perform management functions for the client, or (3) serve in an advocacy role for the client. To do so would impair the auditor’s independence. Based on these three broad principles, the other nonaudit services that an auditor is prohibited from providing to a public company audit client include bookkeeping or other services related to the client’s accounting records or financial statements; financial information systems design and implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services; management or human resources functions; broker or dealer, investment adviser, or investment banking services; legal services and expert services unrelated to the audit; and any other service determined to be impermissible by the PCAOB.

tant, they did place conditions and limitations on internal audit outsourcing.

Depository institutions subject to the annual audit and reporting requirements of section 36 of the FDI Act. Under section 36, as implemented by part 363 of the FDIC's regulations, each FDIC-insured depository institution with total assets of $500 million or more is required to have an annual audit performed by an independent public accountant.[13] The part 363 guidelines address the qualifications of an independent public accountant engaged by such an institution by stating that "[t]he independent public accountant should also be in compliance with the AICPA's *Code of Professional Conduct* and meet the independence requirements and interpretations of the SEC and its staff."[14]

Thus, the guidelines provide for each FDIC-insured depository institution with $500 million or more in total assets, whether or not it is a public company, and its external auditor to comply with the SEC's auditor independence requirements that are in effect during the period covered by the audit. These requirements include the nonaudit-service prohibitions and audit committee preapproval requirements implemented by the SEC's January 2003 auditor independence rules once these rule come into effect.[15]

Institutions not subject to section 36 of the FDI Act that are neither public companies nor subsidiaries of public companies. The agencies have long encouraged each institution not subject to section 36 of the FDI Act that is neither a public company nor a subsidiary of a public company[16] to have its financial statements audited by an independent public accountant.[17] The agencies also encourage each such institution to follow the internal audit outsourcing prohibition in the Sarbanes-Oxley Act, as discussed above for institutions that are public companies.

As previously mentioned, some institutions seek to enhance the quality of their control environment by obtaining the services of an outsourcing vendor who can critically assess their internal control system and recommend improvements. The agencies believe that a small nonpublic institution with less complex operations and limited staff can, in certain circumstances, use the same accounting firm to perform both an external audit and some or all of the institution's internal audit activities. These circumstances include, but are not limited to, situations in which—

- splitting the audit activities poses significant costs or burden;
- persons with the appropriate specialized knowledge and skills are difficult to locate and obtain;
- the institution is closely held and investors are not solely reliant on the audited financial statements to understand the financial position and performance of the institution; and
- the outsourced internal audit services are limited in either scope or frequency.

In circumstances such as these, the agencies view an internal audit outsourcing arrangement between a small nonpublic institution and its external auditor as not being inconsistent with their safety-and-soundness objectives for the institution.

When a small nonpublic institution decides to hire the same firm to perform internal and external audit work, the audit committee and the external auditor should pay particular attention to preserving the independence of both the internal and external audit functions. Furthermore, the audit committee should document both that it has preapproved the internal audit outsourcing to its external auditor and has considered the independence issues associated with this arrangement.[18] In this regard, the audit

13. 12 CFR 363.3(a). (See FDIC Financial Institutions Letter FIL-17-2003 (Corporate Governance, Audits, and Reporting Requirements), attachment II, March 5, 2003.)

14. Appendix A to part 363, Guidelines and Interpretations, paragraph 14, Independence.

15. If a depository institution subject to section 36 and part 363 satisfies the annual independent audit requirement by relying on the independent audit of its parent holding company, once the SEC's January 2003 regulations prohibiting an external auditor from performing internal audit outsourcing services for an audit client take effect May 6, 2003, or May 6, 2004, depending on the circumstances, the holding company's external auditor cannot perform internal audit outsourcing work for that holding company or the subsidiary institution.

16. FDIC-insured depository institutions with less than $500 million in total assets are not subject to section 36 of the FDI Act. Section 36 does not apply directly to holding companies but provides that, for an insured depository institution that is a subsidiary of a holding company, the audited financial statements requirement and certain of the statute's other requirements may be satisfied by the holding company.

17. See, for example, the 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Institutions.

18. If a small nonpublic institution is considering having its external auditor perform other nonaudit services, its audit committee may wish to discuss the implications of the

committee should consider the independence standards described in parts I and II of the policy statement, the AICPA guidance discussed below, and the broad principles that the auditor should not perform management functions or serve in an advocacy role for the client.

Accordingly, the agencies will not consider an auditor who performs internal audit outsourcing services for a small nonpublic audit client to be independent unless the institution and its auditor have adequately addressed the associated independence issues. In addition, the institution's board of directors and management must retain ownership of and accountability for the internal audit function and provide active oversight of the outsourced internal audit relationship.

A small nonpublic institution may be required by another law or regulation, an order, or another supervisory action to have its financial statements audited by an independent public accountant. In this situation, if warranted for safety-and-soundness reasons, the institution's primary federal regulator may require that the institution and its independent public accountant comply with the auditor-independence requirements of the act.[19]

AICPA guidance. As noted above, the independent public accountant for a depository institution subject to section 36 of the FDI Act also should be in compliance with the AICPA's *Code of Professional Conduct.* This code includes professional ethics standards, rules, and interpretations that are binding on all certified public accountants (CPAs) who are members of the AICPA in order for the member to remain in good standing. Therefore, this code applies to each member CPA who provides audit services to an institution, regardless of whether the institution is subject to section 36 or is a public company.

The AICPA has issued guidance indicating that a member CPA would be deemed not independent of his or her client when the CPA acts or appears to act in a capacity equivalent to a member of the client's management or as a client employee. The AICPA's guidance includes illustrations of activities that would be considered to compromise a CPA's independence. Among these are activities that involve the CPA authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the client. For additional details, refer to Interpretation 101-3, Performance of Other Services, and Interpretation 101-13, Extended Audit Services, in the AICPA's *Code of Professional Conduct.*

performance of these services on the auditor's independence.

19. 15 USC 78j-1.

Examination Guidance (Part IV)

Review of the Internal Audit Function and Outsourcing Arrangements

Examiners should have full and timely access to an institution's internal audit resources, including personnel, workpapers, risk assessments, work plans, programs, reports, and budgets. A delay may require examiners to widen the scope of their examination work and may subject the institution to follow-up supervisory actions.

Examiners should assess the quality and scope of an institution's internal audit function, regardless of whether it is performed by the institution's employees or by an outsourcing vendor. Specifically, examiners should consider whether—

- the internal audit function's control risk assessment, audit plans, and audit programs are appropriate for the institution's activities;
- the internal audit activities have been adjusted for significant changes in the institution's environment, structure, activities, risk exposures, or systems;
- the internal audit activities are consistent with the long-range goals and strategic direction of the institution and are responsive to its internal control needs;
- the audit committee promotes the internal audit manager's impartiality and independence by having him or her directly report audit findings to it;
- the internal audit manager is placed in the management structure in such a way that the independence of the function is not impaired;
- the institution has promptly responded to significant identified internal control weaknesses;
- the internal audit function is adequately managed to ensure that audit plans are met, programs are carried out, and the results of audits are promptly communicated to senior management and members of the audit committee and board of directors;

- workpapers adequately document the internal audit work performed and support the audit reports;
- management and the board of directors use reasonable standards, such as the IIA's *Standards for the Professional Practice of Internal Auditing*, when assessing the performance of internal audit; and
- the audit function provides high-quality advice and counsel to management and the board of directors on current developments in risk management, internal control, and regulatory compliance.

The examiner should assess the competence of the institution's internal audit staff and management by considering the education, professional background, and experience of the principal internal auditors. In addition, when reviewing outsourcing arrangements, examiners should determine whether—

- the arrangement maintains or improves the quality of the internal audit function and the institution's internal control;
- key employees of the institution and the outsourcing vendor clearly understand the lines of communication and how any internal control problems or other matters noted by the outsourcing vendor are to be addressed;
- the scope of the outsourced work is revised appropriately when the institution's environment, structure, activities, risk exposures, or systems change significantly;
- the directors have ensured that the outsourced internal audit activities are effectively managed by the institution;
- the arrangement with the outsourcing vendor satisfies the independence standards described in this policy statement and thereby preserves the independence of the internal audit function, whether or not the vendor is also the institution's independent public accountant; and
- the institution has performed sufficient due diligence to satisfy itself of the vendor's competence before entering into the outsourcing arrangement and has adequate procedures for ensuring that the vendor maintains sufficient expertise to perform effectively throughout the arrangement.

Examination concerns about the adequacy of the internal audit function. If the examiner concludes that the institution's internal audit function, whether or not it is outsourced, does not sufficiently meet the institution's internal audit needs; does not satisfy the Interagency Guidelines Establishing Standards for Safety and Soundness, if applicable; or is otherwise inadequate, he or she should determine whether the scope of the examination should be adjusted. The examiner should also discuss his or her concerns with the internal audit manager or other person responsible for reviewing the system of internal control. If these discussions do not resolve the examiner's concerns, he or she should bring these matters to the attention of senior management and the board of directors or audit committee. If the examiner finds material weaknesses in the internal audit function or the internal control system, he or she should discuss them with appropriate agency staff in order to determine the appropriate actions the agency should take to ensure that the institution corrects the deficiencies. These actions may include formal and informal enforcement actions.

The institution's management and composite ratings should reflect the examiner's conclusions regarding the institution's internal audit function. The report of examination should contain comments concerning the adequacy of this function, significant issues or concerns, and recommended corrective actions.

Concerns about the independence of the outsourcing vendor. An examiner's initial review of an internal audit outsourcing arrangement, including the actions of the outsourcing vendor, may raise questions about the institution's and its vendor's adherence to the independence standards described in parts I and II of the policy statement, whether or not the vendor is an accounting firm, and in part III if the vendor provides both external and internal audit services to the institution. In such cases, the examiner first should ask the institution and the outsourcing vendor how the audit committee determined that the vendor was independent. If the vendor is an accounting firm, the audit committee should be asked to demonstrate how it assessed that the arrangement has not compromised applicable SEC, PCAOB, AICPA, or other regulatory standards concerning auditor independence. If the examiner's concerns are not adequately addressed, the examiner should discuss the matter with appropriate agency staff prior to taking any further action.

If the agency staff concurs that the independence of the external auditor or other vendor appears to be compromised, the examiner will discuss his or her findings and the actions the agency may take with the institution's senior management, board of directors (or audit committee), and the external auditor or other vendor. In addition, the agency may refer the external auditor to the state board of accountancy, the AICPA, the SEC, the PCAOB, or other authorities for possible violations of applicable independence standards. Moreover, the agency may conclude that the institution's external auditing program is inadequate and that it does not comply with auditing and reporting requirements, including sections 36 and 39 of the FDI Act and related guidance and regulations, if applicable. *Issued jointly by the Board, FDIC, OCC, and OTS on March 17, 2003.*

SUPPLEMENTAL POLICY STATEMENT ON THE INTERNAL AUDIT FUNCTION AND ITS OUTSOURCING

The Federal Reserve issued this January 23, 2013, policy statement to supplement the guidance in the 2003 ''Interagency Policy Statement on the Internal Audit Function and Its Outsourcing'' (referred to as the 2003 Policy Statement).[19a] Federal Reserve staff has identified areas for improving regulated institutions' internal audit functions. This supplemental policy statement addresses the characteristics, governance, and operational effectiveness of an institution's internal audit function. Further, this statement reflects certain changes in banking regulations that have occurred since the issuance of the 2003 Policy Statement. The Federal Reserve is providing this supplemental guidance to enhance regulated institutions' internal audit practices and to encourage them to adopt professional audit standards and other authoritative guidance, including those issued by the Institute of Internal Auditors (IIA).[19b]

This supplemental statement applies to supervised institutions with greater than $10 billion in total consolidated assets, including state member banks, domestic bank and savings and loan holding companies, and U.S. operations of foreign banking organizations.[19c] This supplemental guidance is also consistent with the objectives of the Federal Reserve's consolidated supervision framework for large financial institutions with total consolidated assets of $50 billion or more, which promotes an independent internal audit function as an essential element for enhancing the resiliency of supervised institutions.[19d]

Overview—Assessment of the Effectiveness of the Internal Audit Function

The degree to which an institution implements the internal audit practices outlined in this policy statement will be considered in the Federal Reserve's supervisory assessment of the effectiveness of an institution's internal audit function as well as its safety and soundness and compliance with consumer laws and regulations. Moreover, the overall effectiveness of an institution's internal audit function will influence the ability of the Federal Reserve to rely upon the work of an institution's internal audit function.

This supplemental policy statement builds upon the 2003 Policy Statement, which remains in effect, and follows the same organizational structure, with a new section entitled ''Enhanced Internal Audit Practices'' and updates to Parts I-IV of the 2003 Policy Statement. Refer to SR-13-1/CA13-1 and its attachment. To avoid historical references and duplication some introductory paragraphs and other small phrases are omitted from the policy statement here, as indicated by a line of asterisks.

* * * * * *

19a. Refer to SR-03-5, ''Amended Interagency Guidance on the Internal Audit Function and Its Outsourcing.''

19b. In this guidance, references have been provided to the IIA's International Standards for the Professional Practice of Internal Auditing (Standards). Refer to the IIA website at https://na.theiia.org/standards-guidance/pages/standards-and-guidance-ippf.aspx.

19c. Section 4 of this document, however, clarifies certain changes to the Federal Deposit Insurance Corporation regulation (12 CFR part 363) on independence standards for independent public accountants at insured depository institutions with total assets of $500 million or more, which were adopted pursuant to 2009 amendments to section 36 of the FDI Act.

19d. Refer to SR-12-17/CA letter 12-14, ''Consolidated Supervision Framework for Large Financial Institutions.''

SUPPLEMENTAL POLICY GUIDANCE

Enhanced Internal Audit Practices

An institution's internal audit function should incorporate the following enhanced practices into their overall processes:

Risk Analysis

Internal audit should analyze the effectiveness of all critical risk-management functions both with respect to individual risk dimensions (for example, credit risk), and an institution's overall risk-management function. The analysis should focus on the nature and extent of monitoring compliance with established policies and processes and applicable laws and regulations within the institution as well as whether monitoring processes are appropriate for the institution's business activities and the associated risks.

Thematic Control Issues

Internal audit should identify thematic macro control issues as part of its risk-assessment processes and determine the overall impact of such issues on the institution's risk profile. Additional audit coverage would be expected in business activities that present the highest risk to the institution. Internal audit coverage should reflect the identification of thematic macro control issues across the firm in all auditable areas. Internal audit should communicate thematic macro control issues to senior management and the audit committee.

In addition, internal audit should identify patterns of thematic macro control issues, determine whether additional audit coverage is required, communicate such control deficiencies to senior management and the audit committee, and ensure management establishes effective remediation mechanisms.

Challenging Management and Policy

Internal audit should challenge management to adopt appropriate policies and procedures and effective controls. If policies, procedures, and internal controls are ineffective or insufficient in a particular line of business or activity, internal audit should report specific deficiencies to senior management and the audit committee with recommended remediation. Such recommendations may include restricting business activity in affected lines of business until effective policies, procedures, and controls are designed and implemented. Internal audit should monitor management's corrective action and conduct a follow-up review to confirm that the recommendations of both internal audit and the audit committee have been addressed.

Infrastructure

When an institution designs and implements infrastructure enhancements, internal audit should review significant changes and notify management of potential internal control issues. In particular, internal audit should ensure that existing, effective internal controls (for example, software applications and management information system reporting) are not rendered ineffective as a result of infrastructure changes unless those controls are compensated for by other improvements to internal controls.

Risk Tolerance

Internal audit should understand risks faced by the institution and confirm that the board of directors and senior management are actively involved in setting and monitoring compliance with the institution's risk tolerance limits. Internal audit should evaluate the reasonableness of established limits and perform sufficient testing to ensure that management is operating within these limits and other restrictions.

Governance and Strategic Objectives

Internal audit should evaluate governance at all management levels within the institution, including at the senior management level, and within all significant business lines. Internal audit should also evaluate the adequacy and effectiveness of controls to respond to risks within the organization's governance, operations, and information systems in achieving the organization's strategic objectives. Any concerns should be communicated by internal audit to the board of directors and senior management.

Internal Audit Function *(Part I of the 2003 Policy Statement)*

The primary objectives of the internal audit function are to examine, evaluate, and perform an independent assessment of the institution's internal control system, and report findings back to senior management and the institution's audit committee. An effective internal audit function within a financial institution is a vital means for an institution's board of directors to maintain the quality of the internal control environment and risk-management systems.

The guidance set forth in this section supplements the existing guidance in the 2003 Policy Statement by strongly encouraging internal auditors to adhere to professional standards, such as the IIA guidance. Furthermore, this section clarifies certain aspects of the IIA guidance and provides practices intended to increase the safety and soundness of institutions.

Attributes of Internal Audit

Independence. Internal audit is an independent function that supports the organization's business objectives and evaluates the effectiveness of risk management, control, and governance processes. The 2003 Policy Statement addressed the structure of an internal audit function, noting that it should be positioned so that an institution's board of directors has confidence that the internal audit function can be impartial and not unduly influenced by managers of day-to-day operations. Thus, the member of management responsible for the internal audit function (hereafter referred to as the chief audit executive or CAE)[19e] should have no responsibility for operating the system of internal control and should report functionally to the audit committee. A reporting arrangement may be used in which the CAE is functionally accountable and reports directly to the audit committee on internal audit matters (that is, the audit plan, audit findings, and the CAE's job performance and compensation) and reports administratively to another senior member of management who is not responsible for operational activities reviewed by internal audit. When there is an administrative reporting of the CAE to another member of senior management, the objectivity of internal audit is served best when the CAE reports administratively to the chief executive officer (CEO).

If the CAE reports administratively to someone other than the CEO, the audit committee should document its rationale for this reporting structure, including mitigating controls available for situations that could adversely impact the objectivity of the CAE. In such instances, the audit committee should periodically (at least annually) evaluate whether the CAE is impartial and not unduly influenced by the administrative reporting line arrangement. Further, conflicts of interest for the CAE and all other audit staff should be monitored at least annually with appropriate restrictions placed on auditing areas where conflicts may occur.

For foreign banking organizations (FBOs), the internal audit function for the U.S. operations of an FBO should have appropriate independent oversight for the total assets of U.S. operations.[19f] When there is a resident U.S. audit function, the CAE of the U.S. audit function should report directly to senior officials of the internal audit department at the head office such as the global CAE. If the FBO has separate U.S. subsidiaries, oversight may be provided by a U.S. based audit committee that meets U.S. public company standards for independence or by the foreign parent company's internal audit function.

Professional competence and staffing. Internal audit staff should have the requisite collective skill levels to audit all areas of the institution. Therefore, auditors should have a wide range of business knowledge, demonstrated through years of audit and industry-specific experience, educational background, professional certifications, training programs, committee participation, professional associations, and job rotational assignments. Internal audit should assign staff to audit assignments based on areas of expertise and, when feasible, rotate staff within the audit function.

Internal audit management should perform knowledge-gap assessments at least annually to evaluate whether current staff members have the knowledge and skills commensurate with the

19e. More recently, this title is used to refer to the person in charge of the internal audit function. An institution may not have a person at the management level of CAE and instead may have an internal audit manager.

19f. This is defined as the combined total assets of U.S. operations, net of all intercompany assets and claims on U.S.-domiciled affiliates.

institution's strategy and operations. Management feedback surveys and internal or external quality assurance findings are useful tools to identify and assess knowledge gaps. Any identified knowledge gaps should be filled and may be addressed through targeted staff hires, training, business line rotation programs, and outsourcing arrangements. The internal audit function should have an effective staff training program to advance professional development and should have a process to evaluate and monitor the quality and appropriateness of training provided to each auditor. Internal auditors generally receive a minimum of forty hours of training in a given year.

Objectivity and ethics. Internal auditors should be objective, which means performing assignments free from bias and interference. A major characteristic of objectivity is that the CAE and all internal audit professional staff avoid any conflicts of interest.[19g] For their first year in the internal audit function, internally recruited internal auditors should not audit activities for which they were previously responsible. Moreover, compensation schemes should not provide incentives for internal auditors to act contrary to the attributes and objectives of the internal audit function.[19h] While an internal auditor may recommend internal control standards or review management's procedures before implementation, objectivity requires that the internal auditor not be responsible for the design, installation, procedures development, or operations of the institution's internal control systems.

An institution's internal audit function should have a code of ethics that emphasizes the principles of objectivity, competence, confidentiality, and integrity, consistent with professional internal audit guidance such as the code of ethics established by the IIA.

Internal audit charter. Each institution should have an internal audit charter that describes the purpose, authority, and responsibility of the internal audit function. An audit charter should include the following critical components:

- The objectives and scope of the internal audit function;
- The internal audit function's management reporting position within the organization, as well as its authority and responsibilities;
- The responsibility and accountability of the CAE; and
- The internal audit function's responsibility to evaluate the effectiveness of the institution's risk management, internal controls, and governance processes.

The charter should be approved by the audit committee of the institution's board of directors. The charter should provide the internal audit function with the authorization to access the institution's records, personnel, and physical properties relevant to the performance of internal audit procedures, including the authority to examine any activities or entities. Periodically, the CAE should evaluate whether the charter continues to be adequate, requesting the approval of the audit committee for any revisions. The charter should define the criteria for when and how the internal audit function may outsource some of its work to external experts.

Corporate Governance Considerations

Board of directors and senior management responsibilities. The board of directors and senior management are responsible for ensuring that the institution has an effective system of internal controls. As indicated in the 2003 Policy Statement, this responsibility cannot be delegated to others within the institution or to external parties. Further, the board of directors and senior management are responsible for ensuring that internal controls are operating effectively.

Audit committee responsibilities. An institution's audit committee is responsible for establishing an appropriate internal audit function and ensuring that it operates adequately and effectively. The audit committee should be confident that the internal audit function addresses the risks and meets the demands posed by the institution's current and planned activities. Moreover, the audit committee is expected to retain oversight responsibility for any aspects of the internal audit function that are outsourced to a third party.

The audit committee should provide oversight to the internal audit function. Audit

19g. IIA standards define conflict of interest as a situation in which an internal auditor, who is in a position of trust, has a competing professional or personal interest. Such competing interests can make it difficult for the individual to fulfill his or her duties impartially.

19h. IIA standards have additional examples of "conflict of interest" for consideration.

committee meetings should be on a frequency that facilitates this oversight and generally should be held four times a year at a minimum, with additional meetings held by audit committees of larger financial institutions. Annually, the audit committee should review and approve internal audit's charter, budget and staffing levels, and the audit plan and overall risk-assessment methodology. The committee approves the CAE's hiring, annual performance evaluation, and compensation.

The audit committee and its chairperson should have ongoing interaction with the CAE separate from formally scheduled meetings to remain current on any internal audit department, organizational, or industry concerns. In addition, the audit committee should have executive sessions with the CAE without members of senior management present as needed.

The audit committee should receive appropriate levels of management information to fulfill its oversight responsibilities. At a minimum, the audit committee should receive the following data with respect to internal audit:

- Audit results with a focus on areas rated less than satisfactory;
- Audit plan completion status and compliance with report issuance timeframes;
- Audit plan changes, including the rationale for significant changes;
- Audit issue information, including aging, past-due status, root-cause analysis, and thematic trends;
- Information on higher-risk issues indicating the potential impact, root cause, and remediation status;
- Results of internal and external quality assurance reviews;
- Information on significant industry and institution trends in risks and controls;
- Reporting of significant changes in audit staffing levels;
- Significant changes in internal audit processes, including a periodic review of key internal audit policies and procedures;
- Budgeted audit hours versus actual audit hours;
- Information on major projects; and
- Opinion on the adequacy of risk-management processes, including effectiveness of management's self-assessment and remediation of identified issues (at least annually).

Role of the chief audit executive. In addition to communicating and reporting to the audit committee on audit-related matters, the CAE is responsible for developing and maintaining a quality assurance and improvement program that covers all aspects of internal audit activity, and for continuously monitoring the effectiveness of the audit function. The CAE and/or senior staff should effectively manage and monitor all aspects of audit work on an ongoing basis, including any audit work that is outsourced.[19i]

The Adequacy of the Internal Audit Function's Processes

Internal audit should have an understanding of the institution's strategy and operating processes as well as the potential impact of current market and macroeconomic conditions on the financial institution. Internal audit's risk-assessment methodology is an integral part of the evaluation of overall policies, procedures, and controls at the institution and the development of a plan to test those processes.

Audit methodology. Internal audit should ensure that it has a well-developed risk-assessment methodology that drives its risk-assessment process. The methodology should include an analysis of cross-institutional risk and thematic control issues and address its processes and procedures for evaluating the effectiveness of risk management, control, and governance processes. The methodology should also address the role of continuous monitoring in determining and evaluating risk, as well as internal audit's process for incorporating other risk identification techniques that the institution's management utilizes such as a risk and control self-assessment (RCSA). The components of an effective methodology should support the internal audit function's assessment of the control environment, beginning with an evaluation of the audit universe.

Audit universe. Internal audit should have effective processes to identify all auditable entities within the audit universe. The number of auditable entities will depend upon whether entities are captured at individual department levels or

19i. The ongoing review of audit work should include risk assessments of audit entities and elements, scope documents, audit programs, detailed audit procedures and steps (including sampling methodologies), audit work papers, audit findings, and monitoring of the timely and effective resolution of audit issues.

at other aggregated organizational levels. Internal audit should use its knowledge of the institution to determine whether it has identified all auditable entities and may use the general ledger, cost centers, new product approval processes, organization charts, department listings, knowledge of the institution's products and services, major operating and application systems, significant laws and regulations, or other data. The audit universe should be documented and reviewed periodically as significant organizational changes occur or at least during the annual audit planning process.

Internal audit risk assessment. A risk assessment should document the internal audit staff's understanding of the institution's significant business activities and the associated risks. These assessments typically analyze the risks inherent in a given business line or process, the mitigating control processes, and the resulting residual risk exposure to the institution.

A comprehensive risk assessment should effectively analyze the key risks (and the critical risk-management functions) within the institution and prioritize audit entities within the audit universe. The risk-assessment process should be well documented and dynamic, reflecting changes to the system of internal controls, infrastructure, work processes, and new or changed business lines or laws and regulations. The risk assessments should also consider thematic control issues, risk tolerance, and governance within the institution. Risk assessments should be revised in light of changing market conditions or laws and regulations and updated during the year as changes are identified in the business activities of the institution or observed in the markets in which the institution operates, but no less than annually. When the risk assessment indicates a change in risk, the audit plan should be reviewed to determine whether the planned audit coverage should be increased or decreased to address the revised assessment of risk.

Risk assessments should be formally documented and supported with written analysis of the risks.[19j] There should be risk assessments for critical risk-management functions within the institution. Risk assessments may be quantitative or qualitative and may include factors such as the date of the last audit, prior audit results, the impact and likelihood of an event occurring, and the status of external vendor relationships. A management RCSA, if performed, may be considered by the internal audit function in developing its independent risk assessment. The internal audit risk assessment should also include a specific rationale for the overall auditable entity risk score. The overall disposition of the risk assessment should be summarized with consideration given to key performance or risk indicators and prior audit results. A high-level summary or discussion of the risk-assessment results should be provided to the audit committee and include the most significant risks facing the institution as well as how these risks have been addressed in the internal audit plan.

Internal audit plan. Internal audit should develop and periodically revise its comprehensive audit plan and ensure that audit coverage for all identified, auditable entities within the audit universe is appropriate for the size and complexity of the institution's activities. This should be accomplished either through a multiyear plan approach, with the plan revised annually, or through an approach that utilizes a framework to evaluate risks annually focusing on the most significant risks. In the latter approach, there should be a mechanism in place to identify when a significant risk will not be audited in the specified timeframe and a requirement to notify the audit committee and seek its approval of any exception to the framework. Generally, common practice for institutions with defined audit cycles is to follow either a three- or four-year audit cycle; high-risk areas should be audited at least every twelve to eighteen months.[19k]

The internal audit plan should consider the risk assessment and internal audit's approach to audit coverage should be appropriate based on the risk assessment. An effective plan covers individual business areas and risk disciplines as well as cross-functional and cross-institutional areas.

The audit planning process should be dynamic, allowing for change when necessary. The process should include a process for modifying the internal audit plan to incorporate significant changes that are identified either through continuous monitoring or during an audit. Any

19j. For example, risks include credit, market, operational, liquidity, compliance, IT, fraud, political, legal, regulatory, strategic, and reputational.

19k. Regardless of the institution's practice, particular care should be taken to ensure that higher-risk elements are reviewed with an appropriate frequency, and not obscured due to their inclusion in a lower risk-rated audit entity.

significant changes should be clearly documented and included in quarterly communications to the audit committee. Critical data to be reported to the audit committee should include deferred or cancelled audits rated high-risk and other significant additions or deletions. Significant changes to audit budgets and timeliness for the completion of audits should be reported to the audit committee with documented rationale.

Internal audit continuous monitoring. Internal audit is encouraged to utilize formal continuous monitoring practices as part of the function's risk-assessment processes to support adjustments to the audit plan or universe as they occur. Continuous monitoring can be conducted by an assigned group or individual internal auditors. An effective continuous monitoring process should include written standards to ensure consistent application of processes throughout the organization.

Continuous monitoring results should be documented through a combination of metrics, management reporting, periodic audit summaries, and updated risk assessments to substantiate that the process is operating as designed. Critical issues identified through the monitoring process should be communicated to the audit committee. Computer-assisted auditing techniques are useful tools to highlight issues that warrant further consideration within a continuous monitoring process.

Internal Audit Performance and Monitoring Processes

Performance. Detailed guidance related to the performance of an internal audit should be documented in the audit manual[19l] and work programs to ensure that audit execution is consistent across the audit function. Internal audit policies and procedures should be designed to ensure that audits are executed in a high-quality manner, their results are appropriately communicated, and issues are monitored and appropriately resolved. In performing internal audit work, an institution should consider the following.

- *Internal audit scope:* During the audit planning process, internal audit should analyze the auditable entity's specific risks, mitigating controls, and level of residual risk. The information gathered during the audit planning phase should be used to determine the scope and specific audit steps that should be performed to test the adequacy of the design and operating effectiveness of control processes.

- *Internal audit work papers:* Work papers document the work performed, observations and analyses made, and support for the conclusions and audit results. The work papers should contain sufficient information regarding any scope or audit program modifications and waiver of issues not included in the final report. Work papers also should document the specific sampling methodology, including minimum sample sizes, and the rationale for such methodology. The work papers should contain information that reflects all phases of the audit process including planning, fieldwork, reporting, and issues tracking and follow-up. On an ongoing basis, a comprehensive supervisory review should be performed on all audit work, including any outsourced internal audit procedures.[19m]

- *Audit report:* Internal audit should have effective processes to ensure that issues are communicated throughout the institution and audit issues are addressed in a timely manner. The audit report should include an executive summary that describes the auditable area, audit's conclusions, the rationale for those conclusions, and key issues. Most audit reports also include management's action plans to address audit findings. To ensure that identified issues are addressed in a timely manner, reports should be issued to affected business areas, senior management, and the audit committee within an appropriate timeframe after the completion of field work. Compliance with issuance timeframes should be monitored and reported periodically to the audit committee. At a minimum, internal audit should ensure that management considers the level and significance of the risk when assigning resources to address and remediate issues. Management should appropriately document the action plans either within the audit report or separately.

19l. To facilitate effective, efficient, and consistent practice within the internal audit department, an institution should develop an audit manual that includes comprehensive policies and procedures and is made available to all internal audit staff. The manual should be updated as needed.

19m. An experienced audit manager should perform this review.

- *Internal audit issues tracking:* Internal audit should have effective processes in place to track and monitor open audit issues and to follow-up on such issues. The timely remediation of open audit issues is an essential component of an organization's risk reduction efforts. Internal audit and the responsible management should discuss and agree to an appropriate resolution date, based on the level of work necessary to complete remediation processes. When an issue owner indicates that work to close an issue is completed, the internal audit function should perform validation work prior to closing the issue. The level of validation necessary may vary based on the issue's risk level. For higher-risk issues, internal audit should perform and document substantive testing to validate that the issue has been resolved. Issues should be tested over an appropriate period of time to ensure the sustainability of the remediation.

Retrospective review processes. When an adverse event occurs at an institution (for example, fraud or a significant loss), management should conduct a post-mortem and ''lessons learned'' analysis. In these situations, internal audit should ensure that such a review takes place and appropriate action is taken to remediate identified issues. The internal audit function should evaluate management's analysis of the reasons for the event and whether the adverse event was the result of a control breakdown or failure, and identify the measures that should be put in place to prevent a similar event from occurring in the future. In certain situations, the internal audit function should conduct its own post-mortem and a ''lessons learned'' analysis outlining the remediation procedures necessary to detect, correct, and/or prevent future internal control breakdowns (including improvements in internal audit processes).

Quality assurance and improvement program. A well-designed, comprehensive quality assurance program should ensure that internal audit activities conform to the IIA's professional standards and the institution's internal audit policies and procedures. The program should include both internal and external quality assessments.

The internal audit function should develop and document its internal assessment program to promote and assess the quality and consistency of audit work across all audit groups with respect to policies, procedures, audit performance, and work papers. The quality assurance review should be performed by someone independent of the audit work being reviewed. Conclusions reached and recommendations for appropriate improvement in internal audit process or staff training should be implemented by the CAE through the quality assurance and improvement program. Action plan progress should be monitored and subsequently closed after a period of sustainability. Each institution should conduct an internal quality assessment annually and the CAE should report the results and status of internal assessments to senior management and the audit committee at least annually.

The IIA recommends that an external quality assessment of internal audit be performed by a qualified independent party at least once every five years. The review should address compliance with the IIA's definition of internal auditing, code of ethics, and standards, as well as with the internal audit function's charter, policies and procedures, and any applicable legislative and regulatory requirements. The CAE should communicate the results, planned actions, and status of remediation efforts to senior management and the audit committee.

Internal Audit Outsourcing Arrangements *(Part II of the 2003 Policy Statement)*

As stated in the 2003 Policy Statement, an institution's board of directors and senior management are charged with the overall responsibility for maintaining an effective system of internal controls. Responsibility for maintaining an effective system of internal controls cannot be delegated to a third party. An institution that chooses to outsource audit work should ensure that the audit committee maintains ownership of the internal audit function. The institution's audit committee and CAE should provide active and effective oversight of outsourced activities. Institutions should carefully consider the oversight responsibilities that are consequential to these types of arrangements in determining appropriate staffing levels.

To distinguish its duties from those of the outsourcing vendor, the institution should have a written contract, which may take the form of an engagement letter or similar services agreement. Contracts between the institution and the vendor should include a provision stating that work papers and any related non-public confidential information and personal information must be handled by the vendor in accordance with applicable laws and regulations. An institution should periodically confirm that the vendor continues to comply with the agreed-upon confidentiality requirements, especially for long-term contracts. The audit committee should approve all significant aspects of outsourcing arrangements and should receive information on audit deficiencies in a manner consistent with that provided by the in-house audit department.

Vendor Competence

An institution should have appropriate policies and procedures governing the selection and oversight of internal audit vendors, including whether to continue with an existing outsourced arrangement. The audit committee and the CAE are responsible for the selection and retention of internal audit vendors and should be aware of factors that may impact vendors' competence and ability to deliver high-quality audit services.

Contingency Planning

An institution's contingency plan should take into consideration the extent to which the institution relies upon outsourcing arrangements. When an institution relies significantly on the resources of an internal audit service provider, the institution should have contingency procedures for managing temporary or permanent disruptions in the service in order to ensure that the internal audit function can meet its intended objectives.

Quality of Audit Work

The quality of audit work performed by the vendor should be consistent with the institution's standards of work expected to be performed by an in-house internal audit department. Further, information supplied by the vendor should provide the board of directors, its audit committee, and senior management with an accurate report on the control environment, including any changes necessary to enhance controls.

Independence Guidance for the Independent Public Accountant *(Part III of the 2003 Policy Statement)*

The following discussion supplements the discussion in Part III of the 2003 Policy Statement and addresses additional requirements regarding auditor independence for depository institutions subject to section 36 of the FDI Act (as amended in 2009).

Depository Institutions Subject to the Annual Audit and Reporting Requirements of Section 36 of the FDI Act

The July 2009 amendments to section 36 of the FDI Act (applicable to insured depository institutions with total assets of $500 million or more) require an institution's external auditor to follow the more restrictive of the independence rules issued by the AICPA, SEC, and PCAOB. In March 2003, the SEC prohibited a registered public accounting firm that is responsible for furnishing an opinion on the consolidated or separate financial statements of an audit client from providing internal audit services to that same client.[19n] Therefore, by following the more restrictive independence rules, a depository institution's external auditor is precluded from performing internal audit services, either on a co-sourced or an outsourced basis, even if the institution is not a public company.

Examination Guidance *(Part IV of the 2003 Policy Statement)*

The following discussion supplements the existing guidance in Part IV of the 2003 Policy Statement on examination guidance and discusses the overall effectiveness of an institution's internal audit function and the examiner's reliance on internal audit.

Determining the Overall Effectiveness of Internal Audit

An effective internal audit function is a vehicle to advance an institution's safety and soundness

19n. See SEC final rule, "Strengthening the Commission's Requirements Regarding Auditor Independence," at 17 CFR parts 210, 240, 249 and 274.

and compliance with consumer laws and regulations and is therefore considered as part of the supervisory review process. Federal Reserve examiners will make an overall determination as to whether the internal audit function and its processes are effective or ineffective and whether examiners can potentially rely upon internal audit's work as part of the supervisory review process. If internal audit's overall processes are deemed effective, examiners may be able to rely on the work performed by internal audit depending on the nature and risk of the functions subject to examination.

The supervisory assessment of internal audit and its effectiveness will consider an institution's application of the 2003 Policy Statement and this supplemental guidance. An institution's internal audit function generally would be considered effective if the institution's internal audit function structure and practices are consistent with the 2003 Policy Statement and this guidance.

Conversely, an institution's internal audit function that does not follow the enhanced practices and supplemental guidance outlined in this policy letter generally will be considered ineffective. In such a case, examiners will not rely on the institution's internal audit function.

Examiners will inform the CAE as to whether the function is deemed to be effective or ineffective. Internal audit's overall processes could be deemed effective even though some aspects of the internal audit function may require enhancements or improvements such as additional documentation with respect to specific audit processes (for example, risk assessments or work papers). In these situations, the required enhancements or improvements generally should not be a critical part of the overall internal audit function, or the function should be deemed to be ineffective.

Relying on the Work Performed by Internal Audit

Examiners may rely on internal audit at supervised institutions if internal audit was deemed effective at the most recent examination of internal audit. In examining an institution's internal audit function, examiners will supplement their examination procedures through continuous monitoring and an assessment of key elements of internal audit, including (1) the adequacy and independence of the audit committee; (2) the independence, professional competence, and quality of the internal audit function; (3) the quality and scope of the audit methodology, audit plan, and risk assessment; and (4) the adequacy of audit programs and work paper standards. On at least an annual basis, examiners should review these key elements to determine whether there have been significant changes in the internal audit infrastructure or whether there are potential concerns regarding their adequacy.

Examiners may choose to rely on the work of internal audit when internal audit's overall function and related processes are effective and when recent work was performed by internal audit in an area where examiners are performing examination procedures. For example, if an internal audit department performs internal audit work in an area where examiners might also review controls, examiners may evaluate whether they can rely on the work of internal audit (and either eliminate or reduce the testing scheduled as part of the regulatory examination processes). In high-risk areas, examiners will consider whether additional examination work is needed even where internal audit has been deemed effective and its work reliable.

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(End of the January 23, 2013, Supplemental Policy Statement)

INDEPENDENCE OF INTERNAL AUDITORS

The ability of the internal audit function to achieve its audit objectives depends, in large part, on the independence maintained by audit personnel. Frequently, the independence of internal auditing can be determined by its reporting lines within the organization and by the person or level to whom these results are reported. In most circumstances, the internal audit function is under the direction of the board of directors or a committee thereof, such as the audit committee. This relationship enables the internal audit function to assist the directors in fulfilling their responsibilities.

The auditor's responsibilities should be addressed in a position description, with reporting lines delineated in personnel policy, and audit results should be documented in audit committee and board of directors' minutes. Examiners should review these documents, as well as the reporting process followed by the auditor, in order to subsequently evaluate the tasks performed by the internal audit function. The internal auditor should be given the authority necessary to perform the job, including free access to any records necessary for the proper conduct of the audit. Furthermore, internal auditors generally should not have responsibility for the accounting system, other aspects of the institution's accounting function, or any operational function not subject to independent review.

Competence of Internal Auditors

The responsibilities and qualifications of internal auditors vary depending on the size and complexity of a bank's operations and on the emphasis placed on the internal audit function by the directorate and management. In many banks, the internal audit function is performed by an individual or group of individuals whose sole responsibility is internal auditing. In other banks, particularly small ones, internal audit may be performed on a part-time basis by an officer or employee.

The qualifications discussed below should not be viewed as minimum requirements but should be considered by the examiner in evaluating the work performed by the internal auditors or audit departments. Examples of the type of qualifications an internal audit department manager should have are—

- academic credentials comparable to other bank officers who have major responsibilities within the organization,
- commitment to a program of continuing education and professional development,
- audit experience and organizational and technical skills commensurate with the responsibilities assigned, and
- oral and written communication skills.

The internal audit department manager must be properly trained to fully understand the flow of data and the underlying operating procedures. Training may come from college courses, courses sponsored by industry groups such as the Bank Administration Institute (BAI), or in-house training programs. Significant work experience in various departments of a bank also may provide adequate training. Certification as a chartered bank auditor, certified internal auditor, or certified public accountant meets educational and other professional requirements. In addition to prior education, the internal auditor should be committed to a program of continuing education, which may include attending technical meetings and seminars and reviewing current literature on auditing and banking.

The internal auditor's organizational skills should be reflected in the effectiveness of the bank's audit program. Technical skills may be demonstrated through internal audit techniques, such as internal control and other questionnaires, and an understanding of the operational and financial aspects of the organization.

In considering the competence of the internal audit staff, the examiner should review the educational and experience qualifications required by the bank for filling the positions in the internal audit department and the training available for that position. In addition, the examiner must be assured that any internal audit supervisor understands the audit objectives and procedures performed by the staff.

In a small bank, it is not uncommon to find that internal audit, whether full- or part-time, is a one-person department. The internal auditor may plan and perform all procedures personally or may direct staff borrowed from other departments. In either case, the examiner should expect, at a minimum, that the internal auditor possesses qualifications similar to those of an audit department manager, as previously discussed.

The final measure of the competence of the internal auditor is the quality of the work performed, the ability to communicate the results of that work, and the ability to follow up on deficiencies noted during the audit work. Accordingly, the examiner's conclusions with respect to an auditor's competence should also reflect the adequacy of the audit program and the audit reports.

IMPLEMENTATION OF THE INTERNAL AUDIT FUNCTION

The annual audit plan and budgets should be set by the internal audit manager and approved by the board, audit committee, or senior management. In many organizations, the internal audit manager reports to a senior manager for administrative purposes. The senior manager appraises the audit manager's performance, and the directors or an audit committee approves the evaluation.

Risk Assessment

In setting the annual audit plan, a risk assessment should be made that documents the internal audit function's understanding of the institution's various business activities and their inherent risks. In addition, the assessment also evaluates control risk, or the potential that deficiencies in the system of internal control would expose the institution to potential loss. The assessment should be periodically updated to reflect changes in the system of internal control, work processes, business activities, or the business environment. The risk-assessment methodology of the internal audit function should identify all auditable areas, give a detailed basis for the auditors' determination of relative risks, and be consistent from one audit area to another. The risk assessment can quantify certain risks, such as credit risk, market risk, and legal risk. It can also include qualitative aspects, such as the timeliness of the last audit and the quality of management. Although there is no standard approach to making a risk assessment, it should be appropriate to the size and complexity of the institution. While smaller institutions may not have elaborate risk-assessment systems, some analysis should still be available to explain why certain areas are more frequently audited than others.

Within the risk assessment, institutions should clearly identify auditable units along business activities or product lines, depending on how the institution is managed. There should be evidence that the internal audit manager is regularly notified of new products, departmental changes, and new general ledger accounts, all of which should be factored into the audit schedule. Ratings of particular business activities or corporate functions may change with time as the internal audit function revises its method for assessing risk. These changes should be incremental. Large-scale changes in the priority of audits should trigger an investigation into the reasonableness of changes to the risk-assessment methodology.

Audit Plan

The audit plan is based on the risk assessment. The plan should include a summary of key internal controls within each significant business activity, the timing and frequency of planned internal audit work, and a resource budget.

A formal, annual audit plan should be developed based on internal audit's risk assessment. The audit plan should include all auditable areas and set priorities based on the rating determined by the risk assessment. The schedule of planned audits should be approved by the board or its audit committee, as should any subsequent changes to the plan. Many organizations develop an audit plan jointly with the external auditors. In this case, the audit plan should clearly indicate what work is being performed by internal and external auditors and what aspects of internal audit work the external auditors are relying on.

Typically, the schedule of audit is cyclic; for example, high risks are audited annually, moderate risks every two years, and low risks every three years. In some cases, the audit cycle may extend beyond three years. In reviewing the annual plan, examiners should determine the appropriateness of the institution's audit cycle. Some institutions limit audit coverage of their low-risk areas. Examiners should review areas the institution has labeled ''low risk'' to determine if the classification is appropriate and if coverage is adequate.

Audit Manual

The internal audit department should have an audit manual that sets forth the standards of work for field auditors and audit managers to use in their assignments. A typical audit manual contains the audit unit's charter and mission, administrative procedures, workpaper-documentation standards, reporting standards, and review procedures. Individual audits should conform to the requirements of the audit manual. As a consequence, the manual should be up-to-date with respect to the audit function's mission and changes to the professional standards it follows.

Performance of Individual Audits

The internal audit manager should oversee the staff assigned to perform the internal audit work and should establish policies and procedures to guide them. The internal audit function should be competently supervised and staffed by people with sufficient expertise and resources to identify the risks inherent in the institution's operations and to assess whether internal controls are effective. While audits vary according to the objective, the area subjected to audit, the standards used as the basis for work performed, and documentation, the audit process generates some common documentation elements, as described below.

Audit Program and Related Workpapers

The audit program documents the audit's objectives and the procedures that were performed. Typically, it indicates who performed the work and who has reviewed it. Workpapers document the evidence gathered and conclusions drawn by the auditor, as well as the disposition of audit findings. The workpapers should provide evidence that the audit program adheres to the requirements specified in the audit manual.

Audit Reports

The audit report is internal audit's formal notice of its assessment of internal controls in the audited areas. The report is given to the area's managers, senior management, and directors. A typical audit report states the purpose of the audit and its scope, conclusions, and recommendations. Reports are usually prepared for each audit. In larger institutions, monthly or quarterly summaries that highlight major audit issues are prepared for senior management and the board.

EXAMINER REVIEW OF INTERNAL AUDIT

The examination procedures section describes the steps the examiner should follow when conducting a review of the work performed by the internal auditor. The examiner's review and evaluation of the internal audit function is a key element in determining the scope of the examination. In most situations, the competence and independence of the internal auditors may be reviewed on an overall basis; however, the adequacy and effectiveness of the audit program should be determined separately for each examination area.

The examiner should assess if the work performed by the internal auditor is reliable. It is often more efficient for the examiner to determine the independence or competence of the internal auditor before addressing the adequacy or effectiveness of the audit program. If the examiner concludes that the internal auditor possesses neither the independence nor the competence deemed appropriate, the examiner must also conclude that the internal audit work performed is not reliable.

The examiner should indicate in the report of examination any significant deficiencies concerning the internal audit function. Furthermore, the examiner should review with management any significant deficiencies noted in the previous report of examination to determine if these concerns have been appropriately addressed.

Program Adequacy and Effectiveness

An examiner should consider the following factors when assessing the adequacy of the internal audit program—

- scope and frequency of the work performed,
- content of the programs,
- documentation of the work performed, and
- conclusions reached and reports issued.

The scope of the internal audit program must be sufficient to attain the audit objectives. The frequency of the audit procedures performed should be based on an evaluation of the risk associated with each targeted area under audit. Among the factors that the internal auditor should consider in assessing risk are the nature of the operation of the specific assets and liabilities under review, the existence of appropriate policies and internal control standards, the effectiveness of operating procedures and internal controls, and the potential materiality of errors or irregularities associated with the specific operation.

To further assess the adequacy and effectiveness of the internal audit program, an examiner needs to obtain audit workpapers. Workpapers should contain, among other things, audit work programs and analyses that clearly indicate the procedures performed, the extent of the testing, and the basis for the conclusions reached.

Although audit work programs are an integral part of the workpapers, they are sufficiently important to deserve separate attention. Work programs serve as the primary guide to the audit procedures to be performed. Each program should provide a clear, concise description of the work required, and individual procedures should be presented logically. The detailed procedures included in the program vary depending on the size and complexity of the bank's operations and the area subject to audit. In addition, an individual audit work program may encompass several departments of the bank, a single department, or specific operations within a department. Most audit programs include procedures such as—

- surprise examinations, where appropriate;
- maintenance of control over records selected for audit;
- review and evaluation of the bank's policies and procedures and the system of internal control;
- reconciliation of detail to related control records; and
- verification of selected transactions and balances through procedures such as examination of supporting documentation, direct confirmation and appropriate follow-up of exceptions, and physical inspection.

The internal auditor should follow the specific procedures included in all work programs to reach audit conclusions that will satisfy the related audit objectives. Audit conclusions should be supported by report findings; such reports should include, when appropriate, recommendations by the internal auditor for any required remedial actions.

The examiner should also analyze the internal reporting process for the internal auditor's findings, since required changes in the bank's internal controls and operating procedures can be made only if appropriate officials are informed of the deficiencies. This means that the auditor must communicate all findings and recommendations clearly and concisely, pinpointing problems and suggesting solutions. The auditor also should submit reports as soon as practical, and the reports should be routed to those authorized to implement the suggested changes.

The final measure of the effectiveness of the audit program is a prompt and effective management response to the auditor's recommendations. The audit department should determine the reasonableness, timeliness, and completeness of management's response to their recommendations, including follow-up, if necessary. Examiners should assess management's response and follow up when the response is either incomplete or unreasonable.

EXTERNAL AUDITS

The Federal Reserve requires bank holding companies with total consolidated assets of $500 million or more to have annual independent audits. Generally, banks must have external audits for the first three years after obtaining FDIC insurance (an FDIC requirement) and upon becoming a newly chartered national bank (an OCC requirement). The SEC also has a longstanding audit requirement for all public companies, which applies to bank holding companies that are SEC registrants and to state member banks that are subject to SEC reporting requirements pursuant to the Federal Reserve's Regulation H.

For insured depository institutions with fiscal years beginning after December 31, 1992, FDICIA, through its amendments to section 36 of the FDI Act, requires annual independent audits for all FDIC-insured banks that have total assets in excess of $500 million. (See SR-94-3 and SR-96-4.) In September 1999, the Federal Financial Institutions Examination Council (FFIEC) issued an interagency policy statement on external auditing programs of banks and savings associations.[20] The policy encourages banks and savings associations that have *less than* $500 million in total assets and that are not subject to other audit requirements to adopt an external auditing program as a part of their overall risk-management process. (See the following subsection for the complete text of the interagency policy statement.)

Independent audits enhance the probability that financial statements and reports to the FRB and other financial-statement users will be accurate and will help detect conditions that could adversely affect banking organizations, the FRB, or the public. The independent audit process also subjects the internal controls and the accounting policies, procedures, and records of each banking organization to periodic review.

Banks often employ external auditors and other specialists to assist management in specialized fields, such as taxation and management information systems. External auditors and consultants often conduct in-depth reviews of the operations of specific bank departments; the reviews might focus on operational procedures, personnel requirements, or other specific areas of interest. After completing the reviews, the auditors may recommend that the bank strengthen controls or improve efficiency.

External auditors provide services at various times during the year. Financial statements are examined annually. Generally, the process commences in the latter part of the year, with the report issued as soon thereafter as possible. Other types of examinations or reviews are performed at various dates on an as-required basis.

The examiner is interested in the work performed by external auditors for three principal reasons. First, situations will arise when internal audit work is not being performed or when such work is deemed to be of limited value to the examiner. Second, the work performed by external auditors may affect the amount of testing the examiner must perform. Third, external audit reports often provide the examiner with information pertinent to the examination of the bank.

The major factors that should be considered in evaluating the work of external auditors are similar to those applicable to internal auditors, namely, the competence and independence of the auditors and the adequacy of the audit program.

The federal banking agencies view a full-scope annual audit of a bank's financial statements by an independent public accountant as preferable to other types of external auditing programs. The September 1999 policy statement recognizes that a full-scope audit may not be feasible for every small bank. It therefore encourages those banks to pursue appropriate alternatives to a full-scope audit. Small banks are also encouraged to establish an audit committee consisting of outside directors. The policy statement provides guidance to examiners on the review of external auditing programs.

The policy statement is consistent with the Federal Reserve's longstanding guidance that encourages the use of external auditing programs, and with its goals for (1) ensuring the accuracy and reliability of regulatory reports, (2) improving the quality of bank internal controls over financial reporting, and (3) enhancing the efficiency of the risk-focused examination process. The Federal Reserve adopted the FFIEC policy statement effective for fiscal years beginning on or after January 1, 2000. (See SR-99-33.)

INTERAGENCY POLICY STATEMENT ON EXTERNAL AUDITING PROGRAMS OF BANKS AND SAVINGS ASSOCIATIONS

Introduction

The board of directors and senior managers of a banking institution or savings association (insti-

20. See 64 *Fed. Reg.* 52319 (September 28, 1999).

tution) are responsible for ensuring that the institution operates in a safe and sound manner. To achieve this goal and meet the safety-and-soundness guidelines implementing section 39 of the Federal Deposit Insurance Act (FDI Act) (12 USC 1831p-1),[21] the institution should maintain effective systems and internal control[22] to produce reliable and accurate financial reports.

Accurate financial reporting is essential to an institution's safety and soundness for numerous reasons. First, accurate financial information enables management to effectively manage the institution's risks and make sound business decisions. In addition, institutions are required by law[23] to provide accurate and timely financial reports (e.g., Reports of Condition and Income [call reports] and Thrift Financial Reports) to their appropriate regulatory agency. These reports serve an important role in the agencies'[24] risk-focused supervision programs by contributing to their pre-examination planning, off-site monitoring programs, and assessments of an institution's capital adequacy and financial strength. Further, reliable financial reports are necessary for the institution to raise capital. They provide data to stockholders, depositors and other funds providers, borrowers, and potential investors on the company's financial position and results of operations. Such information is critical to effective market discipline of the institution.

To help ensure accurate and reliable financial reporting, the agencies recommend that the board of directors of each institution establish and maintain an external auditing program. An external auditing program should be an important component of an institution's overall risk-management process. For example, an external auditing program complements the internal auditing function of an institution by providing management and the board of directors with an independent and objective view of the reliability of the institution's financial statements and the adequacy of its financial-reporting internal controls. Additionally, an effective external auditing program contributes to the efficiency of the agencies' risk-focused examination process. By considering the significant risk areas of an institution, an effective external auditing program may reduce the examination time the agencies spend in such areas. Moreover, it can improve the safety and soundness of an institution substantially and lessen the risk the institution poses to the insurance funds administered by the Federal Deposit Insurance Corporation (FDIC).

This policy statement outlines the characteristics of an effective external auditing program and provides examples of how an institution can use an external auditor to help ensure the reliability of its financial reports. It also provides guidance on how an examiner may assess an institution's external auditing program. In addition, this policy statement provides specific guidance on external auditing programs for institutions that are holding company subsidiaries, newly insured institutions, and institutions presenting supervisory concerns.

The adoption of a financial statement audit or other specified type of external auditing program is generally only required in specific circumstances. For example, insured depository institutions covered by section 36 of the FDI Act (12 USC 1831m), as implemented by part 363 of the FDIC's regulations (12 CFR 363), are required to have an external audit and an audit committee. Therefore, this policy statement is directed toward banks and savings associations which are exempt from part 363 (i.e., institutions with less than $500 million in total assets at the beginning of their fiscal year) or are not otherwise subject to audit requirements by order, agreement, statute, or agency regulations.

Overview of External Auditing Programs

Responsibilities of the Board of Directors

The board of directors of an institution is responsible for determining how to best obtain reasonable assurance that the institution's financial statements and regulatory reports are reliably prepared. In this regard, the board is also responsible for ensuring that its external auditing program is appropriate for the institution and adequately addresses the financial-reporting aspects of the significant risk areas and any other areas of concern of the institution's business.

21. See 12 CFR 30 for national banks; 12 CFR 364 for state nonmember banks; 12 CFR 208 for state member banks; and 12 CFR 510 for savings associations.

22. This policy statement provides guidance consistent with the guidance established in the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing.

23. See 12 USC 161 for national banks; 12 USC 1817a for state nonmember banks; 12 USC 324 for state member banks; and 12 USC 1464(v) for savings associations.

24. Terms are defined at the end of the policy statement.

To help ensure the adequacy of its internal and external auditing programs, the agencies encourage the board of directors of each institution that is not otherwise required to do so to establish an audit committee consisting entirely of outside directors.[25] However, if this is impracticable, the board should organize the audit committee so that outside directors constitute a majority of the membership.

Audit Committee

The audit committee or board of directors is responsible for identifying at least annually the risk areas of the institution's activities and assessing the extent of external auditing involvement needed over each area. The audit committee or board is then responsible for determining what type of external auditing program will best meet the institution's needs (see the descriptions under ''Types of External Auditing Programs'').

When evaluating the institution's external auditing needs, the board or audit committee should consider the size of the institution and the nature, scope, and complexity of its operations. It should also consider the potential benefits of an audit of the institution's financial statements or an examination of the institution's internal control structure over financial reporting, or both. In addition, the board or audit committee may determine that additional or specific external auditing procedures are warranted for a particular year or several years to cover areas of particularly high risk or special concern. The reasons supporting these decisions should be recorded in the committee's or board's minutes.

If, in its annual consideration of the institution's external auditing program, the board or audit committee determines, after considering its inherent limitations, that an agreed-upon procedures/state-required examination is sufficient, they should also consider whether an independent public accountant should perform the work. When an independent public accountant performs auditing and attestation services, the accountant must conduct his or her work under, and may be held accountable for departures from, professional standards. Furthermore, when the external auditing program includes an audit of the financial statements, the board or audit committee obtains an opinion from the independent public accountant stating whether the financial statements are presented fairly, in all material respects, in accordance with generally accepted accounting principles (GAAP). When the external auditing program includes an examination of the internal control structure over financial reporting, the board or audit committee obtains an opinion from the independent public accountant stating whether the financial-reporting process is subject to any material weaknesses.

Both the staff performing an internal audit function and the independent public accountant or other external auditor should have unrestricted access to the board or audit committee without the need for any prior management knowledge or approval. Other duties of an audit committee may include reviewing the independence of the external auditor annually, consulting with management, seeking an opinion on an accounting issue, and overseeing the quarterly regulatory reporting process. The audit committee should report its findings periodically to the full board of directors.

External Auditing Programs

Basic Attributes

External auditing programs should provide the board of directors with information about the institution's financial-reporting risk areas, e.g., the institution's internal control over financial reporting, the accuracy of its recording of transactions, and the completeness of its financial reports prepared in accordance with GAAP.

The board or audit committee of each institution at least annually should review the risks inherent in its particular activities to determine the scope of its external auditing program. For most institutions, the lending and investment-securities activities present the most significant risks that affect financial reporting. Thus, external auditing programs should include specific procedures designed to test at least annually the risks associated with the loan and investment portfolios. This includes testing of internal control over financial reporting, such as management's process to determine the adequacy of the

25. Institutions with $500 million or more in total assets must establish an independent audit committee made up of outside directors who are independent of management. See 12 USC 1831m(g)(1) and 12 CFR 363.5.

allowance for loan and lease losses and whether this process is based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan and lease portfolio.

An institution or its subsidiaries may have other significant financial-reporting risk areas such as material real estate investments, insurance underwriting or sales activities, securities broker-dealer or similar activities (including securities underwriting and investment advisory services), loan-servicing activities, or fiduciary activities. The external auditing program should address these and other activities the board or audit committee determines present significant financial-reporting risks to the institution.

Types of External Auditing Programs

The agencies consider an annual audit of an institution's financial statements performed by an independent public accountant to be the preferred type of external auditing program. The agencies also consider an annual examination of the effectiveness of the internal control structure over financial reporting or an audit of an institution's balance sheet, both performed by an independent public accountant, to be acceptable alternative external auditing programs. However, the agencies recognize that some institutions only have agreed-upon procedures/state-required examinations performed annually as their external auditing program. Regardless of the option chosen, the board or audit committee should agree in advance with the external auditor on the objectives and scope of the external auditing program.

Financial statement audit by an independent public accountant. The agencies encourage all institutions to have an external audit performed in accordance with generally accepted auditing standards (GAAS). The audit's scope should be sufficient to enable the auditor to express an opinion on the institution's financial statements taken as a whole.

A financial statement audit provides assurance about the fair presentation of an institution's financial statements. In addition, an audit may provide recommendations for management in carrying out its control responsibilities. For example, an audit may provide management with guidance on establishing or improving accounting and operating policies and recommendations on internal control (including internal auditing programs) necessary to ensure the fair presentation of the financial statements.

Reporting by an independent public accountant on an institution's internal control structure over financial reporting. Another external auditing program is an independent public accountant's examination and report on management's assertion on the effectiveness of the institution's internal control over financial reporting. For a smaller institution with less complex operations, this type of engagement is likely to be less costly than an audit of its financial statements or its balance sheet. It would specifically provide recommendations for improving internal control, including suggestions for compensating controls, to mitigate the risks due to staffing and resource limitations.

Such an attestation engagement may be performed for all internal controls relating to the preparation of annual financial statements or specified schedules of the institution's regulatory reports.[26] This type of engagement is performed under generally accepted standards for attestation engagements (GASAE).[27]

26. Since the lending and investment-securities activities generally present the most significant risks that affect an institution's financial reporting, management's assertion and the accountant's attestation generally should cover those regulatory report schedules. If the institution has trading or off-balance-sheet activities that present material financial-reporting risks, the board or audit committee should ensure that the regulatory report schedules for those activities also are covered by management's assertion and the accountant's attestation. For banks and savings associations, the lending, investment-securities, trading, and off-balance-sheet schedules consist of:

Area	*Reports of Condition and Income Schedules*	*Thrift Financial Report Schedules*
Loans and lease-financing receivables	RC-C, Part I	SC, CF
Past-due and nonaccrual loans, leases, and other assets	RC-N	PD
Allowance for credit losses	RI-B	SC, VA
Securities	RC-B	SC, SI, CF
Trading assets and liabilities	RC-D	SO, SI
Off-balance-sheet items	RC-L	SI, CMR

These schedules are not intended to address all possible risks in an institution.

27. An attestation engagement is not an audit. It is performed under different professional standards than an audit of an institution's financial statements or its balance sheet.

Balance-sheet audit performed by an independent public accountant. With this program, the institution engages an independent public accountant to examine and report only on the balance sheet. As with the audit of the financial statements, this audit is performed in accordance with GAAS. The cost of a balance-sheet audit is likely to be less than a financial-statement audit. However, under this type of program, the accountant does not examine or report on the fairness of the presentation of the institution's income statement, statement of changes in equity capital, or statement of cash flows.

Agreed-upon procedures/state-required examinations. Some state-chartered depository institutions are required by state statute or regulation to have specified procedures performed annually by their directors or independent persons.[28] The bylaws of many national banks also require that some specified procedures be performed annually by directors or others, including internal or independent persons. Depending upon the scope of the engagement, the cost of agreed-upon procedures or a state-required examination may be less than the cost of an audit. However, under this type of program, the independent auditor does not report on the fairness of the institution's financial statements or attest to the effectiveness of the internal control structure over financial reporting. The findings or results of the procedures are usually presented to the board or the audit committee so that they may draw their own conclusions about the quality of the financial reporting or the sufficiency of internal control.

When choosing this type of external auditing program, the board or audit committee is responsible for determining whether these procedures meet the external auditing needs of the institution, considering its size and the nature, scope, and complexity of its business activities. For example, if an institution's external auditing program consists solely of confirmations of deposits and loans, the board or committee should consider expanding the scope of the auditing work performed to include additional procedures to test the institution's high-risk areas. Moreover, a financial statement audit, an examination of the effectiveness of the internal control structure over financial reporting, and a balance-sheet audit may be accepted in some states and for national banks in lieu of agreed-upon procedures/state-required examinations.

Other Considerations

Timing. The preferable time to schedule the performance of an external auditing program is as of an institution's fiscal year-end. However, a quarter-end date that coincides with a regulatory report date provides similar benefits. Such an approach allows the institution to incorporate the results of the external auditing program into its regulatory reporting process and, if appropriate, amend the regulatory reports.

External auditing staff. The agencies encourage an institution to engage an independent public accountant to perform its external auditing program. An independent public accountant provides a nationally recognized standard of knowledge and objectivity by performing engagements under GAAS or GASAE. The firm or independent person selected to conduct an external auditing program and the staff carrying out the work should have experience with financial-institution accounting and auditing or similar expertise and should be knowledgeable about relevant laws and regulations.

Special Situations

Holding Company Subsidiaries

When an institution is owned by another entity (such as a holding company), it may be appropriate to address the scope of its external audit program in terms of the institution's relationship to the consolidated group. In such cases, if the group's consolidated financial statements for the same year are audited, the agencies generally would not expect the subsidiary of a holding company to obtain a separate audit of its financial statements. Nevertheless, the board of directors or audit committee of the subsidiary may determine that its activities involve significant risks to the subsidiary that are not within the procedural scope of the audit of the financial statements of the consolidated entity. For example, the risks arising from the subsidiary's

28. When performed by an independent public accountant, "specified procedures" and "agreed-upon procedures" engagements are performed under standards, which are different professional standards than those used for an audit of an institution's financial statements or its balance sheet.

activities may be immaterial to the financial statements of the consolidated entity, but material to the subsidiary. Under such circumstances, the audit committee or board of the subsidiary should consider strengthening the internal audit coverage of those activities or implementing an appropriate alternative external auditing program.

Newly Insured Institutions

Under the FDIC statement of policy on applications for deposit insurance, applicants for deposit insurance coverage are expected to commit the depository institution to obtain annual audits by an independent public accountant once it begins operations as an insured institution and for a limited period thereafter.

Institutions Presenting Supervisory Concerns

As previously noted, an external auditing program complements the agencies' supervisory process and the institution's internal auditing program by identifying or further clarifying issues of potential concern or exposure. An external auditing program also can greatly assist management in taking corrective action, particularly when weaknesses are detected in internal control or management information systems affecting financial reporting.

The agencies may require a financial institution presenting safety-and-soundness concerns to engage an independent public accountant or other independent external auditor to perform external auditing services.[29] Supervisory concerns may include—

- inadequate internal control, including the internal auditing program;
- a board of directors generally uninformed about internal control;
- evidence of insider abuse;
- known or suspected defalcations;
- known or suspected criminal activity;
- probable director liability for losses;
- the need for direct verification of loans or deposits;
- questionable transactions with affiliates; or
- the need for improvements in the external auditing program.

The agencies may also require that the institution provide its appropriate supervisory office with a copy of any reports, including management letters, issued by the independent public accountant or other external auditor. They also may require the institution to notify the supervisory office prior to any meeting with the independent public accountant or other external auditor at which auditing findings are to be presented.

Examiner Guidance

Review of the External Auditing Program

The review of an institution's external auditing program is a normal part of the agencies' examination procedures. An examiner's evaluation of, and any recommendations for improvements in, an institution's external auditing program will consider the institution's size; the nature, scope, and complexity of its business activities; its risk profile; any actions taken or planned by it to minimize or eliminate identified weaknesses; the extent of its internal audit program; and any compensating controls in place. Examiners will exercise judgment and discretion in evaluating the adequacy of an institution's external auditing program.

Specifically, examiners will consider the policies, processes, and personnel surrounding an institution's external auditing program in determining whether—

- the board of directors or its audit committee adequately reviews and approves external auditing program policies at least annually;
- the external auditing program is conducted by an independent public accountant or other independent auditor and is appropriate for the institution;
- the engagement letter covering external auditing activities is adequate;
- the report prepared by the auditor on the results of the external auditing program adequately explains the auditor's findings;
- the external auditor maintains appropriate

29. The Office of Thrift Supervision requires an external audit by an independent public accountant for savings associations with a composite rating of 3, 4, or 5 under the Uniform Financial Institution Rating System, and on a case-by-case basis.

independence regarding relationships with the institution under relevant professional standards;
- the board of directors performs due diligence on the relevant experience and competence of the independent auditor and staff carrying out the work (whether or not an independent public accountant is engaged); and
- the board or audit committee minutes reflect approval and monitoring of the external auditing program and schedule, including board or committee reviews of audit reports with management and timely action on audit findings and recommendations.

Access to Reports

Management should provide the independent public accountant or other auditor with access to all examination reports and written communication between the institution and the agencies or state bank supervisor since the last external auditing activity. Management also should provide the accountant with access to any supervisory memoranda of understanding, written agreements, administrative orders, reports of action initiated or taken by a federal or state banking agency under section 8 of the FDI Act (or a similar state law), and proposed or ordered assessments of civil money penalties against the institution or an institution-related party, as well as any associated correspondence. The auditor must maintain the confidentiality of examination reports and other confidential supervisory information.

In addition, the independent public accountant or other auditor of an institution should agree in the engagement letter to grant examiners access to all the accountant's or auditor's workpapers and other material pertaining to the institution prepared in the course of performing the completed external auditing program.

Institutions should provide reports[30] issued by the independent public accountant or other auditor pertaining to the external auditing program, including any management letters, to the agencies and any state authority in accordance with their appropriate supervisory office's guidance.[31] Significant developments regarding the external auditing program should be communicated promptly to the appropriate supervisory office. Examples of those developments include the hiring of an independent public accountant or other third party to perform external auditing work and a change in, or termination of, an independent public accountant or other external auditor.

Definitions

Agencies. The agencies are the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

Appropriate supervisory office. The regional or district office of the institution's primary federal banking agency responsible for supervising the institution or, in the case of an institution that is part of a group of related insured institutions, the regional or district office of the institution's federal banking agency responsible for monitoring the group. If the institution is a subsidiary of a holding company, the term "appropriate supervisory office" also includes the federal banking agency responsible for supervising the holding company. In addition, if the institution is state-chartered, the term "appropriate supervisory office" includes the appropriate state bank or savings association regulatory authority.

Audit. An examination of the financial statements, accounting records, and other supporting evidence of an institution performed by an independent certified or licensed public accountant in accordance with generally accepted

30. The institution's engagement letter is not a "report" and is not expected to be submitted to the appropriate supervisory office unless specifically requested by that office.

31. When an institution's financial information is included in the audited consolidated financial statements of its parent company, the institution should provide a copy of the audited financial statements of the consolidated company and any other reports by the independent public accountant in accordance with their appropriate supervisory office's guidance. If several institutions are owned by one parent company, a single copy of the reports may be supplied in accordance with the guidance of the appropriate supervisory office of each agency supervising one or more of the affiliated institutions and the holding company. A transmittal letter should identify the institutions covered. Any notifications of changes in, or terminations of, a consolidated company's independent public accountant may be similarly supplied to the appropriate supervisory office of each supervising agency.

auditing standards (GAAS) and of sufficient scope to enable the independent public accountant to express an opinion on the institution's financial statements as to their presentation in accordance with generally accepted accounting principles (GAAP).

Audit committee. A committee of the board of directors whose members should, to the extent possible, be knowledgeable about accounting and auditing. The committee should be responsible for reviewing and approving the institution's internal and external auditing programs or recommending adoption of these programs to the full board.

Balance-sheet audit performed by an independent public accountant. An examination of an institution's balance sheet and any accompanying footnotes performed and reported on by an independent public accountant in accordance with GAAS and of sufficient scope to enable the independent public accountant to express an opinion on the fairness of the balance-sheet presentation in accordance with GAAP.

Engagement letter. A letter from an independent public accountant to the board of directors or audit committee of an institution that usually addresses the purpose and scope of the external auditing work to be performed, period of time to be covered by the auditing work, reports expected to be rendered, and any limitations placed on the scope of the auditing work.

Examination of the internal control structure over financial reporting. See "Reporting by an independent public accountant on an institution's internal control structure over financial reporting."

External auditing program. The performance of procedures to test and evaluate high-risk areas of an institution's business by an independent auditor, who may or may not be a public accountant, sufficient for the auditor to be able to express an opinion on the financial statements or to report on the results of the procedures performed.

Financial statement audit by an independent public accountant. See Audit.

Financial statements. The statements of financial position (balance sheet), income, cash flows, and changes in equity together with related notes.

Independent public accountant. An accountant who is independent of the institution and registered or licensed to practice, and holds himself or herself out, as a public accountant, and who is in good standing under the laws of the state or other political subdivision of the United States in which the home office of the institution is located. The independent public accountant should comply with the American Institute of Certified Public Accountants' (AICPA) Code of Professional Conduct and any related guidance adopted by the Independence Standards Board and the agencies. No certified public accountant or public accountant will be recognized as independent who is not independent both in fact and in appearance.

Internal auditing. An independent assessment function established within an institution to examine and evaluate its system of internal control and the efficiency with which the various units of the institution are carrying out their assigned tasks. The objective of internal auditing is to assist the management and directors of the institution in the effective discharge of their responsibilities. To this end, internal auditing furnishes management with analyses, evaluations, recommendations, counsel, and information concerning the activities reviewed.

Outside directors. Members of an institution's board of directors who are not officers, employees, or principal stockholders of the institution, its subsidiaries, or its affiliates, and who do not have any material business dealings with the institution, its subsidiaries, or its affiliates.

Regulatory reports. These reports are the Reports of Condition and Income (call reports) for banks, Thrift Financial Reports (TFRs) for savings associations, Federal Reserve (FR) Y reports for bank holding companies, and the H-(b)11 Annual Report for thrift holding companies.

Reporting by an independent public accountant on an institution's internal control structure over financial reporting. Under this engagement, management evaluates and documents its review of the effectiveness of the institution's internal control over financial reporting in the identified risk areas as of a specific report date. Management prepares a written assertion, which specifies the criteria on which management based its evaluation about the effectiveness of the institution's internal control over financial reporting in the identified risk areas and states management's opinion on the effectiveness of internal control over this specified financial reporting. The independent public accountant is engaged to perform tests on the internal control over the specified financial reporting in order to attest to management's assertion. If the accountant concurs with management's assertion, even if the assertion discloses one or more instances of material internal control weakness, the accountant would provide a report attesting to management's assertion.

Risk areas. Those particular activities of an institution that expose it to greater potential losses if problems exist and go undetected. The areas with the highest financial-reporting risk in most institutions generally are their lending and investment-securities activities.

Specified procedures. Procedures agreed upon by the institution and the auditor to test its activities in certain areas. The auditor reports findings and test results, but does not express an opinion on controls or balances. If performed by an independent public accountant, these procedures should be performed under generally accepted standards for attestation engagements (GASAE).

Issued by the FFIEC on September 28, 1999.

UNSAFE AND UNSOUND USE OF LIMITATION OF LIABILITY PROVISIONS IN EXTERNAL AUDIT ENGAGEMENT LETTERS

On February 9, 2006, the Federal Reserve and the other financial institution regulatory agencies (the agencies)[32] issued an interagency advisory (the advisory) to address safety-and-soundness concerns that may arise when financial institutions enter into external audit contracts (typically referred to as *engagement letters*) that limit the auditors' liability for audit services.[33] The advisory informs financial institutions'[34] boards of directors, audit committees, management, and external auditors of the safety-and-soundness implications that may arise when the financial institution enters into engagement letters that contain provisions to limit the auditors' liability. Such provisions may weaken the external auditors' objectivity, impartiality, and performance and, thus, reduce the agencies' ability to rely on audits. Therefore, certain limitation-of-liability provisions (described in the advisory) are unsafe and unsound. In addition, such provisions may not be consistent with the auditor-independence standards of the SEC, the PCAOB, and the AICPA.

The advisory does not apply to previously executed engagement letters. However, any financial institution subject to a multiyear audit engagement letter containing unsafe and unsound limitation-of-liability provisions should seek an amendment to its engagement letter to be consistent with the advisory for periods ending in 2007 or later. (See SR-06-4.)

Scope of the Advisory on Engagement Letters

The advisory applies to engagement letters between financial institutions and external auditors with respect to financial-statement audits, audits of internal control over financial reporting, and attestations on management's assessment of internal control over financial reporting (collectively, *audit* or *audits*).

The advisory does not apply to—

- nonaudit services that may be performed by financial institutions' external auditors,
- audits of financial institutions' 401(k) plans, pension plans, and other similar audits,
- services performed by accountants who are not engaged to perform financial institutions' audits (e.g., outsourced internal audits or loan reviews), and
- other service providers (e.g., software consultants or legal advisers).

While the agencies have observed several

32. The Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA).

33. The advisory is effective for audit engagement letters issued on or after February 9, 2006.

34. As used in this advisory, the term *financial institutions* includes banks, bank holding companies, savings associations, savings and loan holding companies, and credit unions.

types of limitation-of-liability provisions in external audit engagement letters, this advisory applies to any agreement that a financial institution enters into with its external auditor that limits the external auditor's liability with respect to audits in an unsafe and unsound manner.

External Audits and Their Engagement Letters

A properly conducted audit provides an independent and objective view of the reliability of a financial institution's financial statements. The external auditor's objective in an audit is to form an opinion on the financial statements taken as a whole. When planning and performing the audit, the external auditor considers the financial institution's internal control over financial reporting. Generally, the external auditor communicates any identified deficiencies in internal control to management, which enables management to take appropriate corrective action. In addition, certain financial institutions are required to file audited financial statements and internal control audit or attestation reports with one or more of the agencies. The agencies encourage financial institutions not subject to mandatory audit requirements to voluntarily obtain audits of their financial statements. The FFIEC's *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations* notes,[34a] "[a]n institution's internal and external audit programs are critical to its safety and soundness." The policy also states that an effective external auditing program "can improve the safety and soundness of an institution substantially and lessen the risk the institution poses to the insurance funds administered by the FDIC."

Typically, a written engagement letter is used to establish an understanding between the external auditor and the financial institution regarding the services to be performed in connection with the financial institution's audit. The engagement letter commonly describes the objective of the audit, the reports to be prepared, the responsibilities of management and the external auditor, and other significant arrangements (for example, fees and billing). Boards of directors, audit committees, and management are encouraged to closely review all of the provisions in the audit engagement letter before agreeing to sign. As with all agreements that affect a financial institution's legal rights, the financial institution's legal counsel should carefully review audit engagement letters to help ensure that those charged with engaging the external auditor make a fully informed decision.

The advisory describes the types of objectionable limitation-of-liability provisions and provides examples.[35] Financial institutions' boards of directors, audit committees, and management should also be aware that certain insurance policies (such as error and omission policies and directors' and officers' liability policies) might not cover losses arising from claims that are precluded by limitation-of-liability provisions.

Limitation-of-Liability Provisions

The provisions of an external audit engagement letter that the agencies deem to be unsafe and unsound can be generally categorized as follows: a provision within an agreement between a client financial institution and its external auditor that effectively—

- indemnifies the external auditor against claims made by third parties;
- holds harmless or releases the external auditor from liability for claims or potential claims that might be asserted by the client financial institution, other than claims for punitive damages; or
- limits the remedies available to the client financial institution, other than punitive damages.

Collectively, these categories of provisions are referred to in this advisory as *limitation-of liability-provisions.*

Provisions that waive the right of financial institutions to seek punitive damages from their external auditor are not treated as unsafe and unsound under the advisory. Nevertheless, agree-

34a. See 64 *Fed. Reg.* 52319 (September 28, 1999).

35. In the majority of external audit engagement letters reviewed, the agencies did not observe provisions that limited an external auditor's liability. However, for those reviewed external audit engagement letters that did have external auditor limited-liability provisions, the agencies noted a significant increase in the types and frequency of the provisions. The provisions took many forms, which made it impractical for the agencies to provide an all-inclusive list. Examples of auditor limitation-of-liability provisions are illustrated in the advisory's appendix A, which can be found in section A.1010.1 of this manual.

ments by clients to indemnify their auditors against any third-party damage awards, including punitive damages, are deemed unsafe and unsound under the advisory. To enhance transparency and market discipline, public financial institutions that agree to waive claims for punitive damages against their external auditors may want to disclose annually the nature of these arrangements in their proxy statements or other public reports.

Many financial institutions are required to have their financial statements audited, while others voluntarily choose to undergo such audits. For example, federally insured banks with $500 million or more in total assets are required to have annual independent audits.[36] Furthermore, financial institutions that are public companies[37] must have annual independent audits. The agencies rely on the results of audits as part of their assessment of a financial institution's safety and soundness.

For audits to be effective, the external auditors must be independent in both fact and appearance, and they must perform all necessary procedures to comply with auditing and attestation standards established by either the AICPA or, if applicable, the PCAOB. When financial institutions execute agreements that limit the external auditors' liability, the external auditors' objectivity, impartiality, and performance may be weakened or compromised, and the usefulness of the audits for safety-and-soundness purposes may be diminished.

By their very nature, limitation-of-liability provisions can remove or greatly weaken external auditors' objective and unbiased consideration of problems encountered in audit engagements and may diminish auditors' adherence to the standards of objectivity and impartiality required in the performance of audits. The existence of such provisions in external audit engagement letters may lead to the use of less extensive or less thorough procedures than would otherwise be followed, thereby reducing the reliability of audits. Accordingly, financial institutions should not enter into external audit arrangements that include unsafe and unsound limitation-of-liability provisions identified in the advisory, regardless of (1) the size of the financial institution, (2) whether the financial institution is public or not, or (3) whether the external audit is required or voluntary.

36. For banks, see section 36 of the FDI Act (12 USC 1831m) and part 363 of the FDIC's regulations (12 CFR 363).

37. Public companies are companies subject to the reporting requirements of the Securities Exchange Act of 1934.

Auditor Independence

Currently, auditor-independence standard-setters include the SEC, PCAOB, and AICPA. Depending on the audit client, an external auditor is subject to the independence standards issued by one or more of these standard-setters. For all nonpublic financial institutions that are not required to have annual independent audits, the FDIC's rules, pursuant to part 363, require only that an external auditor meet the AICPA independence standards. The rules do not require the financial institution's external auditor to comply with the independence standards of the SEC and the PCAOB.

In contrast, for financial institutions subject to the audit requirements in part 363 of the FDIC's regulations, the external auditor should be in compliance with the AICPA's Code of Professional Conduct and meet the independence requirements and interpretations of the SEC and its staff.[38] In this regard, in a December 13, 2004, frequently asked question (FAQ) on the application of the SEC's auditor-independence rules, the SEC staff reiterated its long-standing position that when an accountant and his or her client enter into an agreement that seeks to provide the accountant immunity from liability for his or her own negligent acts, the accountant is not independent. The FAQ also stated that including in engagement letters a clause that would release, indemnify, or hold the auditor harmless from any liability and costs resulting from knowing misrepresentations by management would impair the auditor's independence.[39] The FAQ is consistent with the SEC's Codification of Financial Reporting Policies, section 602.02.f.i , "Indemnification by Client." (See section A.1010.1 of this manual.)

On the basis of the SEC guidance and the agencies' existing regulations, certain limits on

38. See part 363 of the FDIC's regulation (12 CFR 363), *Appendix A—Guidelines and Interpretations,* Guideline 14, *"Role of the Independent Public Accountant-Independence."*

39. In contrast to the SEC's position, AICPA Ethics Ruling 94 (ET, section 191.188–189) currently concludes that indemnification for "knowing misrepresentations by management" does *not* impair independence.

auditors' liability are already inappropriate in audit engagement letters entered into by—

- public financial institutions that file reports with the SEC or with the agencies,
- financial institutions subject to part 363, and
- certain other financial institutions that are required to have annual independent audits.

In addition, certain of these limits on auditors' liability may violate the AICPA independence standards. Notwithstanding the potential applicability of auditor-independence standards, the limitation-of-liability provisions discussed in the advisory present safety-and-soundness concerns for all financial institution audits.

Alternative Dispute-Resolution Agreements and Jury-Trial Waivers

The agencies observed that a review of the engagement letters of some financial institutions revealed that they had agreed to submit disputes over external audit services to mandatory and binding alternative dispute resolution, binding arbitration, or other binding nonjudicial dispute-resolution processes (collectively, *mandatory ADR*) or to waive the right to a jury trial. By agreeing in advance to submit disputes to mandatory ADR, financial institutions may waive the right to full discovery, limit appellate review, or limit or waive other rights and protections available in ordinary litigation proceedings.

Mandatory ADR procedures and jury-trial waivers may be efficient and cost-effective tools for resolving disputes in some cases. Accordingly, the agencies believe that mandatory ADR or waiver of jury-trial provisions in external audit engagement letters do not present safety-and-soundness concerns, provided that the engagement letters do not also incorporate limitation-of-liability provisions. Institutions are encouraged to carefully review mandatory ADR and jury-trial provisions in engagement letters, as well as review any agreements regarding rules of procedure, and to fully comprehend the ramifications of any agreement to waive any available remedies. Financial institutions should ensure that any mandatory ADR provisions in audit engagement letters are commercially reasonable and—

- apply equally to all parties,
- provide a fair process (for example, neutral decision makers and appropriate hearing procedures), and
- are not imposed in a coercive manner.

The Advisory's Conclusion

Financial institutions' boards of directors, audit committees, and management should not enter into any agreement that incorporates limitation-of-liability provisions with respect to audits. In addition, financial institutions should document their business rationale for agreeing to any other provisions that limit their legal rights.

The inclusion of limitation-of-liability provisions in external audit engagement letters and other agreements that are inconsistent with the advisory will generally be considered an unsafe and unsound practice. Examiners will consider the policies, processes, and personnel surrounding a financial institution's external auditing program in determining whether (1) the engagement letter covering external auditing activities raises any safety-and-soundness concerns and (2) the external auditor maintains appropriate independence regarding relationships with the financial institution under relevant professional standards. The agencies may take appropriate supervisory action if unsafe and unsound limitation-of-liability provisions are included in external audit engagement letters or other agreements related to audits that are executed (accepted or agreed to by the financial institution).

CERTIFIED PUBLIC ACCOUNTANTS

This section discusses the standards for competence and independence of certified public accountants (CPAs) as well as the standards required in connection with their audits.

Standards of Conduct

The Code of Professional Ethics for CPAs who are members of the American Institute of Certified Public Accountants (AICPA) requires that audits be performed according to generally accepted auditing standards (GAAS). GAAS, as distinct from generally accepted accounting principles, or GAAP, are concerned with the auditor's professional qualifications, the judgment the auditor exercises in the performance of an audit, and the quality of the audit procedures.

On the other hand, GAAP represents all of the conventions, rules, and procedures that are necessary to define accepted accounting practices at a particular time. GAAP includes broad guidelines of general application and detailed practices and procedures that have been issued by the Financial Accounting Standards Board (FASB), the AICPA, the SEC, or other authoritative bodies that set accounting standards. Thus, GAAP provides guidance on financial-reporting and disclosure matters.

Generally Accepted Auditing Standards

GAAS are grouped into three categories: general standards, standards of field work, and standards of reporting.

The *general standards* require that the audit be performed by a person or persons having adequate technical training and proficiency; that independence in mental attitude be maintained; and that due professional care be exercised in the performance of the audit and the preparation of the report.

Standards of field work require that the work be adequately planned; assistants, if any, be properly supervised; a proper study and evaluation of existing internal controls be made for determining the audit scope and the audit procedures to be performed during the audit; and sufficient evidence be obtained to formulate an opinion regarding the financial statements under audit.

Standards of reporting require that the CPA state whether the financial statements are presented in accordance with GAAP. The application of GAAP in audited financial statements and reports must achieve the fundamental objectives of financial accounting, which are to provide reliable financial information about the economic resources and obligations of a business enterprise. In addition, the informative disclosures in the financial statements must follow GAAP, or the CPA must state otherwise in the report.

GAAS recognizes that management—not the CPA—has primary responsibility for the preparation of the financial statements and the presentations therein. The auditor's responsibility is to express an opinion on the financial statements. GAAS (or the audit requirements previously set forth) require that audits cover the following financial statements: balance sheet, income statement, statement of changes in stockholders' equity, and statement of cash flows.

GAAS require that CPAs plan and perform auditing procedures to obtain reasonable assurance that financial statements are free from material misstatement. Under GAAS, an audit includes examining on a test basis and should include evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial-statement presentation.

Independence

In the performance of their work, CPAs must be independent of those they serve. Traditionally, independence has been defined as the ability to act with integrity and objectivity. In accordance with the rule on independence included in the SEC's independence rules and the Code of Professional Ethics and related AICPA interpretations, the independence of a CPA is considered to be impaired if, during the period of his or her professional engagement, the CPA or his or her firm had any direct or material indirect financial interest in the enterprise or had any loan to or from the enterprise or any officer, director, or principal stockholder thereof. The latter prohibition does not apply to the following loans from a financial institution when made under normal lending procedures, terms, and requirements:

- automobile loans and leases collateralized by the automobile
- loans in the amount of the cash surrender value of a life insurance policy
- borrowings fully collateralized by cash deposits at the same financial institution (for example, passbook loans)
- credit cards and cash advances under lines of credit associated with checking accounts with aggregate unpaid balances of $5,000 or less

Such loans must, at all times, be kept current by the CPA as to all terms.

Other loans have been grandfathered by the AICPA under recent ethics interpretations. These other loans (mortgage loans, other secured loans, and loans not material to the AICPA member's net worth) must, at all times, be current as to all terms and shall not be renegotiated with the client financial institution after the latest of—

- January 1, 1992;
- the date that the financial institution first becomes a client;
- the date the loans are sold from a nonclient financial institution to the client financial institution; or
- the date of becoming a member in the AICPA.

The examiner may decide under certain circumstances to test the independence of the CPA through reviews of loan listings, contracts, stockholder listings, and other appropriate measures. Concerns about independence should be identified in the report of examination.

The SEC has also released guidance relating to the independence of auditors for public institutions. According to SEC Rule 101, the independence of an auditor would be impaired if financial, employment, or business relationships exist between auditors and audit clients, and if there are relationships between auditors and audit clients in which the auditors provide certain nonaudit services to their audit clients. Much of the language found in the SEC's independence rules is incorporated in the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing.

EXTERNAL AUDIT REPORTS

The external auditor generates various types of reports and other documents. These reports typically include—

- the standard audit report, which is generally a one-page document;
- a "management letter" in which the auditor confidentially presents detailed findings and recommendations to management; and
- an attestation report in which the auditor attests to management's assertion of internal controls and procedures over financial reports (for public companies and institutions subject to section 36 of the FDI Act); and
- other reports from the auditor to regulators during the audit period.

The major types of standard audit reports will never have a heading or other statement in the report that identifies which type it is. Rather, the type of report is identified by certain terminology used in the text of the report. The major types of standard audit reports are described below.

The *unqualified report,* sometimes referred to as a *clean opinion,* states that the financial statements are "presented fairly" in conformity with GAAP and that the necessary audit work was done.

The *qualified report* may generally have the same language as the unqualified report but will use the phrase "except for" or some other qualification to indicate that some problem exists. The types of problems include a lack of sufficient evidential matter, restrictions on the scope of audit work, or departures from GAAP in the financial statements. This type of report is not necessarily negative but indicates that the examiner should ask additional questions of management.

An *adverse report* basically concludes that the financial statements are not presented fairly in conformity with GAAP. This type of report is rarely issued because auditors and management usually work out their differences in advance.

A *disclaimer* expresses no opinion on the financial statements. CPAs may issue a disclaimer when they have concluded that substantial doubt exists about the ability of the institution to continue as a going concern for a reasonable period of time. This disclaimer is intended to indicate that the CPA is not assuming any responsibility for these statements.

REVIEW OF THE EXTERNAL AUDITOR'S INDEPENDENCE AND AUDIT

Because of the professional and ethical standards of the public accounting profession, the Federal Reserve has concluded that the examiner should conduct an in-depth review of the competence and independence of the CPA only in unusual situations. One such situation would be a recent change in CPAs by a bank, particularly if the change was made after an audit had commenced.

Ordinarily, specific tests to determine independence are not necessary. However, there may be occasions when the examiner has sufficient reason to question the independence of a CPA or the quality of his or her work. For example, the examiner may discover that during the period of a CPA's professional engagement, which includes the period covered by the financial statements on which the CPA has expressed an opinion, the CPA or a member of his or her firm—

- had a direct financial interest in the bank;
- was connected with the bank in a capacity equivalent to that of a member of management or was a director of the bank;
- maintained, completely or in part, the books and records of the bank and did not perform audit tests with respect to such books and records; or
- had a prohibited loan from the bank (as discussed earlier).

In these and similar instances, the CPA would not have complied with professional standards.

The examiner should determine the scope of the CPA's examination by reviewing the most recent report issued by the CPA. If the audit is in progress or is planned to commence in the near future, the examiner should review any engagement letter to the bank from the CPA. The examiner also should obtain and review any adjusting journal entries suggested by the CPA at the conclusion of the examination. This should be done to determine whether such entries were the result of breakdowns in the internal control structure and procedures for financial reporting.

Under certain circumstances, a CPA may issue a qualified or adverse opinion or may disclaim an opinion on a bank's financial statements. In such circumstances, the examiner should first determine the reasons for the particular type of opinion issued. If the matters involved affect specific areas of the bank's operations, a review of the work performed by the CPA may help the examiner understand the problem that gave rise to this opinion. The examination procedures (section 1010.3) describes the steps the examiner should follow when conducting a review of the work performed by the CPA. (See the FFIEC interagency Policy Statement on the External Auditing Programs of Banks and Savings Associations (effective January 1, 2000) (SR-99-33)).

LIMITATIONS OF AUDITS AND AUDITED FINANCIAL STATEMENTS

Although auditing standards are designed to require the use of due care and objectivity, a properly designed and executed audit does not necessarily guarantee that all misstatements of amounts or omissions of disclosure in the financial statements have been detected. Moreover, a properly designed and executed audit does not guarantee that the auditor addressed FRB safety-and-soundness considerations. Examination personnel should be cognizant of the limitations inherent in an audit. The following examples illustrate some common limitations of audits:

- The auditor is not responsible for deciding whether an institution operates wisely. An unqualified audit report means that the transactions and balances are reported in accordance with GAAP. It does not mean that the transactions made business sense, that the associated risks are managed in a safe and sound manner, or that the balances can be recovered upon disposition or liquidation.
- The auditor's report concerning financial statements does not signify that underwriting standards, operating strategies, loan-monitoring systems, and workout procedures are adequate to mitigate losses if the environment changes. The auditor's report that financial statements fairly present the bank's financial position is based on the prevailing evidence and current environment, and it indicates that reported assets can be recovered in the normal course of business. In determining that reported assets can be recovered in the normal course of business, the auditor attempts to understand financial-reporting internal controls and can substitute other audit procedures when these controls are weak or nonexistent.
- The quality of management and how it manages risk are not considered in determining historical cost and its recoverability. Although certain assets and instruments are marked to market (for example, trading accounts), GAAP generally uses historical cost as the basis of presentation. Historical cost assumes that the entity is a going concern. The going-concern concept allows certain mark-to-market losses

to be deferred because management believes the cost basis can be recovered during the remaining life of the asset.
- GAAP financial statements offer only limited disclosures of risks, uncertainties, and the other safety-and-soundness factors on which the institution's viability depends.
- Under GAAP, loan-loss reserves are provided for "probable losses" currently "inherent" (that is, anticipated future charge-offs are based on current repayment characteristics) in the portfolio. GAAP defines probable as the likelihood that a future event will occur, confirming the fact of the loss. Additionally, the amount of the loss must be reasonably estimable.

COMMUNICATION WITH EXTERNAL AUDITORS

GAAS requires that the external auditor can consider regulatory authorities as a source of competent evidential matter when conducting an audit of the financial statements of a banking organization. Accordingly, an external auditor may review communications from, and make inquiries of, the regulatory authorities.

Generally, the Federal Reserve encourages auditors to attend examination exit conferences upon completion of the examiner's field work or to attend other meetings concerning examination findings between supervisory examiners and an institution's management or board of directors (or a committee thereof). Banks should ensure that their external auditors are informed in a timely manner of scheduled exit conferences and other relevant meetings with examiners and of the FRB's policies regarding auditor attendance at such meetings.

When other conferences between examiners and management are scheduled (those that do not involve examination findings that are relevant to the scope of the external auditor's work), the institution should first obtain the approval of the appropriate Federal Reserve Bank personnel for the auditor to attend the meetings. The interagency policy statement of July 23, 1992, does not preclude the Federal Reserve from holding meetings with the management of banks without auditor attendance or from requiring that the auditor attend only certain portions of the meetings. (See SR-92-28.)

The 1992 interagency policy statement was issued to improve coordination and communication between external auditors and examiners. Examination personnel should provide banking organizations with advance notice of the starting date of the examination when appropriate, so management can inform external auditors in advance and facilitate the planning and scheduling of their audit work.

Some institutions prefer that audit work be completed at different times than examination work to reduce demands on their staff members and facilities. Other institutions prefer to have audit work and examination work performed during similar periods so the institution's operations are affected only at certain times during the year. By knowing when examinations are planned, institutions have the flexibility to schedule external audit work concurrent with, or separate from, examinations.

Meetings and Discussions Between External Auditors and Examiners

An external auditor may request a meeting with the FRB regulatory authorities involved in the supervision of the institution or its holding company during or after completion of examinations to inquire about supervisory matters relevant to the institution under audit. External auditors should provide an agenda in advance. The FRB regulatory authorities will generally request that management of the institution under audit be represented at the meeting. In this regard, examiners will generally only discuss with an auditor examination findings that have been presented to bank management.

In certain cases, external auditors may wish to discuss with examiners matters relevant to the institution without bank management representation. External auditors may request such confidential meetings with the FRB regulatory authorities, who may also request such meetings with the external auditor.

Information Required to Be Made Available to External Auditors

Section 931 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and section 112 of FDICIA (12 USC 1811) pertain to depository institutions insured by the FDIC that have engaged the services of an external auditor to audit the banking organization within the past two years. FIRREA and FDICIA require banks to provide the auditor with copies of the most recent Report of Condition (Call Report), report of examination, and pertinent correspondence or reports received from its regulator. This information is to be provided to the external auditor by the bank under audit, not by the FRB. In addition, banking organizations must provide the independent auditor with—

- a copy of any supervisory memorandum of understanding or written agreement between a federal or state banking agency and the bank put into effect during the period covered by the audit, and
- a report of any formal action taken by a federal or state banking agency during such period, or any civil money penalty assessed with respect to the bank or any banking organization–affiliated party.

Regulatory personnel should ascertain if the banking organization is in compliance with the requirements of section 931 of FIRREA (12 USC 1817(a)) and section 112 of FDICIA and should report instances of noncompliance in the report of examination.

Confidentiality of Supervisory Information

While the policies of the FRB regulatory authorities permit external auditors to have access to the information described above, institutions and their auditors are reminded that information contained in examination reports, inspection reports, and supervisory discussions—including any summaries or quotations—is confidential supervisory information and must not be disclosed to any party without the written permission of the FRB. Unauthorized disclosure of confidential supervisory information may lead to civil and criminal actions and fines and other penalties.

1. To determine whether internal and external audit functions exist.
2. To determine with reasonable assurance that the bank has an adequate internal audit function that ensures efficient and effective operations, including the safeguarding of assets, reliable financial reporting, and compliance with applicable laws and regulations.
3. To ascertain, through the examination process, that the bank's internal audit function monitors, reviews, and ensures the continued existence and maintenance of sound and adequate internal controls over the bank's management process—the control environment, risk assessment, control activities, information and communication, and monitoring activities.
4. To review and evaluate internal audit outsourcing arrangements and the actions of the outsourcing vendor under the standards established by the 2003 "Interagency Policy Statement on the Internal Audit Function and Its Outsourcing" and the Federal Reserve's 2013 "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing."
5. To evaluate the independence and competence of those who provide the internal and external audit functions.
6. To consider the policies, processes, and personnel surrounding the bank's external auditing program and to determine if—
   a. any engagement letter or other agreement related to external audit activities for the bank
      (1) provides any assurances of indemnification to the bank's external auditors that relieves them of liability for their own negligent acts (including any losses, claims, damages, or other liabilities) or
      (2) raises any other safety-and soundness-concerns; and
   b. the external auditors have maintained appropriate independence in their relationships with the bank, in accordance with relevant professional standards.
7. To determine the adequacy of the procedures performed by the internal and external auditors.
8. To determine, based on the criteria above, if the work performed by internal and external auditors is reliable.
9. To make an overall determination as to whether the internal audit function and its processes are effective or ineffective and whether examiners can potentially rely upon internal audit's work as part of the supervisory review process.
10. For high-risk areas, to make a determination as to whether additional examination work is needed even where internal audit may be deemed effective and its work reliable.

This examination program should be used in conjunction with the audit function and audit outsourcing questionnaire section to review the bank's internal and external audits and the audit procedures they encompass. The audit guidelines are general, and all sections or questions may not be applicable to every bank.

Before reviewing any specific audit procedures, the examiner should first determine the independence and competence of the auditors. If the examiner believes the auditors to be both competent and independent, he or she should then determine the effectiveness and adequacy of their work, and whether the auditors made an assessment as to whether the institution's internal audit function incorporated the enhanced practices outlined in the Federal Reserve's "Supplemental Policy Statement on Internal Audit Function and Its Outsourcing" (Supplemental Guidance) into their overall processes.

Based on the answers to the audit function questions and on the auditor's work, the examiner must then determine the scope of the examination. The program and related supporting documentation should be completed in an organized manner and should be retained as part of the examination workpapers.

Upon completion of the program, the examiner should be able to formulate a conclusion on the effectiveness of audit processes and coverage. Conclusions about any weaknesses in the internal or external audit work performed for the bank should be summarized and included in the report of examination. Matters Requiring Immediate Attention (MRIA) or Matters Requiring Attention (MRA) to be included in the report of examination should be discussed with the audit committee, the Chief Audit Executive (CAE) and senior bank management.

INTERNAL AUDITORS

1. *Organizational structure of the audit department.* Review the internal audit's organization chart for direct and indirect reporting lines of the CAE and the minutes of the board's audit or examining committee to determine how effectively the CAE and board of directors are discharging their responsibility. If the CAE reports to someone other than the chief executive officer (CEO), determine if the audit committee has documented its rationale for the reporting structure, including any mitigating controls for situations that could adversely impact the objectivity of the CAE. Determine if the audit committee has quarterly, but at least annually, evaluated whether (1) the CAE is impartial and not unduly influenced by the administrative reporting line, and (2) any conflicts of interest for the CAE and other audit staff are accompanied by appropriate restrictions to mitigate those conflicts.
2. *Independence of the audit function.* Interview the CAE and observe the operation of the audit department to determine its functional responsibilities.
3. *CAE's qualifications.* Review biographical data and interview the CAE to determine his or her ability to manage the institution's internal audit function and his or her responsibility in the institution.
4. *Audit staff qualifications.* Review the biographical data and interview the management staff of the audit department to determine their qualifications commensurate with their delegated responsibilities compared to the institution's strategy and operations. Review the educational background, professional certifications, and relevant banking and audit experience of staff to assess overall staff qualifications and to identify any knowledge gaps.
5. *Skills gap assessments.* Review how often they are performed, and how gaps in coverage are addressed (e.g., targeted staff hires, training, business-line rotation programs, and co-sourcing/outsourcing arrangements).
6. *Training.* Ensure there is a process in place to determine and monitor the annual training, typically 40 hours minimum, for each staff member based on their needs.
7. *Content and use of the audit frequency and scope schedule.* Review the methodology utilized to determine the audit universe and frequency of coverage per auditable entity.
8. *Audit department participation in systems design projects.* Determine through interviews and documentation reviews, internal audit's role in assessing systems change

control processes.

9. *Internal audit charter.* Review the internal audit charter to determine its current adequacy. Determine whether the CAE periodically reviews the current adequacy of the charter and makes recommendations to the audit committee for improving internal audit function and whether outsourcing to external experts may be needed.
10. *Audit manual.* Review the audit manual to ensure that it includes all applicable audit processes, practices, and procedures, and applicable references to Institute of Internal Auditor (IIA) standards.
11. *Maintenance of audit records.* Review a sample of the audit reports and associated workpapers to determine compliance with prescribed procedures and proper documentation, including appropriate distribution to senior managers.
12. *Audit department's formal reporting procedures.* Review CAE presentations and MIS reporting to the audit or examining committee to ensure the committee is providing effective oversight of the internal audit function.
13. *Issue tracking follow-up processes.* Review processes utilized to validate closure of internal audit findings. Review a sample of closed issues to ensure audit maintains sufficient documentation to validate issue closure.
14. *Use and effectiveness of audit computer programs.* Interview the CAE and/or the appropriate staff members regarding the use of the computer and access to the files for audit purposes. Obtain or perform a walkthrough of automated auditing systems and methodologies.

QUALITY ASSURANCE

1. *Internal quality assurance.* Ensure process is documented in the audit manual. Review sample of work, overall results, and status of any action plans.
2. *External quality assurance.* Determine whether an independent assessment had been performed within the five-year requirement. Review results and action plan status to remediate issues.

INTERNAL AUDIT FUNCTION ADEQUACY AND EFFECTIVENESS

1. *Examination scope.* Adjust the scope of the examination if the bank's internal audit function does not sufficiently meet the bank's internal audit needs (whether or not the audit function is outsourced), does not satisfy the Interagency Guidelines Establishing Standards for Safety and Soundness, or is otherwise ineffective.
2. *Adequacy of the internal audit function's processes.* Determine if internal audit has a well-developed understanding of the institution's strategy and operational processes and the potential market impact of current market and macroeconomic conditions within its current operational financial environment.
   a. *Audit methodology.* Review the internal audit's risk-assessment methodology that drives its risk-assessment process and determine if it represents the audit universe. Determine if the methodology included a documented analysis of cross-institutional risk and thematic control issues and the processes and procedures for evaluating the effectiveness of risk-management, control, and governance processes. Evaluate internal audit's plan for continuous monitoring and in determining and evaluating risk. Assess internal audit's process for incorporating other risk-identification techniques (i.e., risk and control self-assessment) that the institution's management utilizes.
   b. *Audit universe.* Determine if internal audit has effective processes to identify all auditable entities within the audit universe. Review the documentation of the audit universe and verify whether it has been reviewed periodically (e.g., during the annual audit planning process) and when significant organizational changes have occurred.
   c. *Internal audit risk assessment.* Review internal audit's documentation of its understanding of the institution's significant business activities and their associated risks. Verify that internal audit includes, at least annually, a review of critical risk-management functions as well as changes in the system of internal

controls, infrastructure, work processes, new or changed business lines, or laws and regulations. Review the disposition of the results of the overall risk-assessment summary and determine if internal audit gave consideration to key performance or risk indicators and the most significant risks facing the institution, including how the risks are addressed within the internal audit plan.

d. *Internal audit plan.* Verify that internal audit develops and periodically revises its comprehensive audit plan. Determine if it verifies that the plan includes audit coverage for all identified, auditable entities within the audit universe appropriate for the size and complexity of the institution's activities.

3. *Internal audit performance and monitoring processes.*
   a. Determine if the *audit manual and work programs* contain detailed guidance related to the performance of the audit and whether they are consistent across the audit function.
   b. Ascertain if *audit planning* included an analysis of the entity's specific risks, mitigating controls, and level of residual risk.
   c. Determine if the *internal audit workpapers* adequately document the work program; the work performed; and workpaper standards, including documentation of any observations and analysis made, the conclusions, and audit results.
   d. *Audit report.*
      1) Ascertain that internal audit has effective audit reporting processes that communicate audit report issues throughout the institution and that they are addressed in a timely manner.
      2) Review the examination period's audit reports and verify that they contain an executive summary describing the auditable area, its conclusions, rationale, key issues, and management's documented action plans to address audit findings.
   e. *Audit issues tracking and quality assurance review processes.*
      1) Verify that internal audit has effective processes in place to track, monitor, and follow up on open audit issues.
      2) Determine if the institution conducts independent quality assurance reviews of internal audit work performed.
      3) Verify that the CAE implements appropriate improvements in internal audit processes or staff training through the quality assurance and improvement programs.
      4) Determine whether the institution conducts an internal quality assessment at least annually and if the CAE reports the results and status of internal assessments to senior management and the audit committee at least annually.
      5) Discuss supervisory concerns and outstanding internal-external audit report comments with the CAE or other person responsible for reviewing the system of internal control. If these discussions do not resolve the examiner's comments and concerns, bring these matters to the attention of senior management and the board of directors or the audit committee.

EXAMINATION FINDINGS AND CONCLUSIONS ON INTERNAL AUDIT FUNCTION

1. If material weaknesses in the internal audit function or the internal control system exist, discuss them with appropriate Federal Reserve Bank supervisory staff to determine the appropriate actions (including formal and informal enforcement actions) that should be taken to ensure that the bank corrects the deficiencies.
2. Incorporate conclusions about the bank's internal audit function into the bank's management and composite supervisory ratings.
3. Include in the report of examination comments concerning the effectiveness of the internal audit function, significant issues or concerns, and recommended corrective actions.

INDEPENDENCE OF THE OUTSOURCING VENDOR

1. If the initial review of an internal audit outsourcing arrangement, including the actions of the outsourcing vendor, raises questions about the bank's and its vendor's adherence to the independence standards

(discussed in parts I, II, and III of the 2003 "Interagency Policy Statement on the Internal Audit Function and Its Outsourcing"), verify that the vendor does not provide both external and internal audit services to the bank.

a. Ask the bank's audit committee how they determined that the outsourced vendor was independent.
b. If the vendor is an accounting firm, ask the audit committee how they assessed that the arrangement had not compromised applicable Securities and Exchange Commission, Public Company Accounting Oversight Board, American Institute of Certified Public Accountants, or other regulatory standards concerning auditor independence.
c. If the answers to the above supervisory concerns are not adequately addressed, discuss the matter with appropriate Reserve Bank supervisory staff.
d. If the Reserve Bank supervisory staff concurs that the independence of the external auditor or other vendor appears to be compromised, discuss the examination findings and the supervisory actions that may be taken with the bank's senior management, board of directors (or audit committee), and the external auditor or other vendor.[1]

EXTERNAL AUDITORS

1. Review any pending, current, or past engagement letters and agreements, if the bank has engaged any external audit firms to conduct audits of its financial statements (including their certification), audits of internal control over financial reporting, attestations on management's assessment of internal control, appraisals of the bank's audit function, any internal audit, or audit function or operational review. Determine if the audit engagement letters or other agreements include unsafe and unsound provisions that—
   a. indemnify the external auditor against all claims made by third parties;
   b. hold harmless, release, or indemnify the external auditor from liability for claims or potential claims that the bank may assert (other than claims for punitive damages), thus providing relief from liability for the auditors' own negligent acts, including any losses, claims, damages, or other liabilities; or
   c. limit the remedies available to the bank (other than punitive damages).
2. Verify that—
   a. the audit committee maintains ownership of the audit function;
   b. the bank's board of directors, audit committee, and senior management closely review all of the provisions of audit engagement letters or other agreements for providing external auditing services for the bank before agreeing to sign them, thus indicating the bank's approval and financial commitment;
   c. the institution's audit committee and CAE provide active leadership and the institution's audit committee and CAE provide effective oversight of outsourced activities; and
   d. the external auditor has provided the board of directors, its audit committee, and senior management with an accurate report on the control environment, including any changes necessary to enhance controls.
3. Verify that the bank has documented its business rationale for any engagement letter or other agreement provisions with external audit firms that limit or impair the bank's legal rights.
4. With the cooperation of the audit committee, review and determine the effectiveness of the bank's external auditors' reports, letters, or correspondence, including their supporting workpapers, for the audit work performed since the previous examination.

REGULATORY EXAMINATIONS

1. Review any functional regulatory examination or supervisory examination report for work performed since the previous state member bank examination. Interview any involved auditors to determine their responsibilities and extent of involvement with the work in this area.

1. A depository institution's external auditor is precluded from performing internal audit services, either on a co-outsourced or an outsourced basis, even if the institution is not a public company.

2. At least annually, review and make an assessment of the key elements of internal audit to determine whether there have been significant changes in the internal audit infrastructure or whether there are potential concerns regarding their adequacy.
3. For high-risk areas, consider whether additional examination work is needed even where internal audit has been deemed effective and its work is reliable.

Review the documentation as instructed in the examination procedures section to answer the following audit function and audit outsourcing questions. Where appropriate, supporting documentation and pertinent information should be retained or noted under comments. If the institution is at a Federal Reserve supervised institution with greater than $10 billion in total consolidated assets, (including state member banks, domestic bank and savings and loan holding companies, and U.S. operations of foreign banks), then the institution should comply with SR-13-1/CA-13-1, "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing."

ORGANIZATIONAL STRUCTURE AND INTERNAL CONTROL ENVIRONMENT OF THE AUDIT DEPARTMENT

1. Has the board of directors delegated responsibility for the audit function? If so, to whom?
2. Has the board of directors established an audit committee? Is it composed solely of outside directors?[1]
3. Are the members of the audit committee qualified for their particular responsibilities?
4. Does the audit committee promote the internal audit manager's impartiality and independence by having him or her directly report audit findings to it? How often does the audit committee meet with the Chief Audit Executive (CAE) to review audit metrics and significant audit findings, including thematic issues?
5. Does the audit committee retain a portion of its meeting to meet directly with the CAE?
6. Do the minutes of the audit committee indicate an appropriate interest in the committee's activities and findings?
7. Does the CAE report directly to the board of directors, the audit committee (or other independent board level committee)? If not, to whom does the CAE directly report? Is there an administrative reporting line to a senior-management-level officer who is not responsible for operational activities (ideally the chief executive officer (CEO))? If the reporting line is not to the CEO, has the audit committee approved this and documented the mitigating controls as to why it is not a conflict of interest?
8. Are the internal audit function's control risk assessment, audit plans, and audit programs appropriate for the bank's activities? For institutions in scope for SR-13-1/CA-13-1, has the audit department incorporated the enhanced internal audit practices, described in the SR Letter, into its processes?
9. Are internal audit activities consistent with the long-range goals and strategic direction of the bank, and are they responsive to its internal control needs?
10. Do the board of directors and the audit committee use reasonable standards, such as the Institute of Internal Auditors' (IIA) Standards for the Professional Practice of Internal Auditing, when assessing the performance of internal audit?
11. Does the audit function provide high-quality advice and counsel to management and the board of directors on current developments in risk management, internal control, and regulatory compliance?

INDEPENDENCE AND MANAGEMENT OF THE AUDIT FUNCTION

1. Is the audit department functionally segregated from operations in the organizational structure?
2. Does the audit committee review or approve the internal audit charter; budget and staffing levels; audit plan; and the CAE's hiring, annual performance evaluation, and compensation. If not, who does?
3. Does the CAE report directly to the audit committee on internal audit matters? Are the reporting procedures of the CAE independent of operational activities and influence of any operating personnel?
4. Does the CAE report administratively to the CEO or another senior member of

1. See this manual's section 1010.1 for requirements for audit committee composition.

management that is not responsible for operational activities reviewed by internal audit? If the latter, has the audit committee documented its rationale for this reporting structure, including mitigating controls available for situations that could adversely impact the objectivity of the CAE?

5. Is the internal audit function adequately managed to ensure that audit plans are accomplished and the audit results are promptly communicated to the audit committee, senior management, and the board of directors?
6. Do the responsibilities of the audit staff exclude any duties to be performed in lieu of operating personnel, such as preparation or approval of general ledger entries, official checks, daily reconcilements, dual control, etc.?

CAE'S QUALIFICATIONS

1. Are the CAE's and senior audit officials' academic credentials comparable to other bank officers who have major responsibilities within the organization?
2. Does the CAE and/or other senior staff have relevant business knowledge, substantive audit and industry-specific experience, educational background, and professional certifications?
3. Is the CAE's experience in both auditing and banking comparable both in quality and in duration to that required of the officers assigned major responsibilities?
4. Does the CAE communicate and relate well with all levels of personnel?
5. Does the CAE demonstrate a commitment to continuing education and a current knowledge of the latest developments in banking and auditing technology?
6. Is the CAE dedicated to the standards and ethics of his or her profession (such as those published by the Bank Administration Institute, the Institute of Internal Auditors, and the American Institute of Certified Public Accountants)?

AUDIT STAFF QUALIFICATIONS

1. Is the audit staff sufficient in number to perform its tasks adequately?
2. Is the staff adequately experienced in auditing and banking? Does the audit staff have the requisite collective education background, industry-specific experience, professional certifications, and skill levels to audit all areas of the institution?
3. Are members of the staff experienced in specialized areas, such as information technology, foreign-exchange trading, trust, and subsidiary activities of the bank?
4. Is there a formal audit training program in effect which includes sufficient training time for staff based on their experience?
5. Is the number of unfilled vacancies on the audit staff considered reasonable?
6. Is the turnover of audit personnel acceptable?
7. Does management have plans to improve its audit capability, if needed?

ADEQUACY OF THE INTERNAL AUDIT FUNCTION'S PROCESSES

1. Does internal audit have a well-developed understanding of the institution's strategy and operational processes as well as the potential market impact of current market and macroeconomic conditions within its current operational financial environment?
2. Does internal audit have a well-developed risk-assessment methodology that drives the risk-assessment process? Does the risk-assessment methodology effectively risk rank the audit universe? Are audit cycles or specific audit timeframes established with an emphasis on high-risk areas and are they appropriate?
   a. *Audit methodology.* Does internal audit's risk-assessment methodology include—
      1) a documented analysis of cross-institutional risk and thematic control issues;
      2) the processes and procedures for evaluating the effectiveness of risk-management and control; and
      3) governance processes?
   b. *Audit universe.* Has internal audit documented effective processes that will identify all auditable entities within the audit universe, and are the processes reviewed periodically?
   c. *Internal audit risk assessment.* Has internal audit documented its understanding

of the institution's significant business activities and associated risks? Does it perform, at least annually, a review of critical risk-management functions; changes in the system of internal controls, infrastructure, and work processes; and new or changed business lines or laws and regulations? Did internal audit give consideration to key performance or risk indicators and the most significant risks facing the institution, including how the risks are addressed within the internal audit plan?

d. *Internal audit plan.* Does internal audit develop and periodically revise its comprehensive audit plan? Does internal audit verify that the plan includes audit coverage for all identified, auditable entities within the audit universe appropriate for the size and complexity of the institution's activities?

Internal Audit Performance and Monitoring Processes

1. Do the *audit manual and work programs* contain detailed guidance related to the performance of the audit and an evaluation as to whether they are consistent across the audit function?
2. Did the *audit planning process* include an analysis of the entity's specific risks, mitigating controls, and level of residual risk?
3. Do the *internal audit workpapers* adequately document the work programs, the work performed, and the workpaper standards, including documentation of any observations and analysis made, the conclusions, and audit results?

Audit Report

1. Does internal audit have effective audit reporting processes that communicate audit report issues throughout the institution, and are the report issues addressed in a timely manner?
2. Do the audit reports contain an executive summary describing the auditable area, its conclusions, rationale, key issues, and management's documented action plans to address audit findings?

Audit Issues Tracking and Retrospective Review Processes

1. Does internal audit have effective processes in place to track, monitor, and follow up on open audit issues?
2. Does the institution conduct independent quality assurance reviews of internal audit work performed, and are the results reported at least annually by the CAE to the audit committee and senior management?

Adequacy and Effectiveness of Internal Audit

1. Has the CAE and audit committee monitored and made a documented assessment of the key elements of internal audit as to—
   a. independence of internal audit;
   b. the professional competence and quality of the internal audit function;
   c. the quality and scope of the audit methodology;
   d. the adequacy of audit programs and workpaper standards; and
   e. whether there were any significant changes in the internal audit infrastructure or concerns about their adequacy?

CONTENT AND USE OF THE AUDIT FREQUENCY AND SCOPE SCHEDULE

1. Is the audit program formalized and therefore on record as a commitment that can be analyzed and reviewed?
2. Are all important bank functions and services identified as subjects of the audits? What processes are used to establish the audit universe (e.g., organizational charts, general ledger chart of accounts, new product approval process)?
3. Does the audit program include procedures necessary to ensure compliance with all applicable laws and regulations, especially Bank Secrecy Act and anti-money laundering requirements?
4. Does the internal audit department have access to all reports, records, and minutes?
5. For institutions in scope for SR-13-1/CA-13-1, are all high-risk areas audited within 12 to 18 months?

6. Are internal audit activities adjusted for significant changes in the bank's environment, structure, new products and activities, risk exposures, or systems?
7. Does the frequency and scope schedule require approval by the audit committee, the board of directors, regulatory authorities, or others? If so, by whom, and has such approval been obtained?
8. Does the frequency and scope schedule comply with statutory requirements, if any, for internal audits, including minimum audit standards?
9. Does the CAE periodically report his or her progress in completing the frequency and scope schedule to the board's audit committee?
   a. If not to the board's audit committee, to whom?
   b. Does the committee approve significant deviations, if any, in the original program?
10. Does the CAE prepare a time budget? Are budgeted versus actual time analyses used as a guide in forward planning?
11. Does the depth of coverage appear to be sufficient?
12. Are different entry dates and time periods between reviews scheduled so as to frustrate reliable anticipation of entry dates by auditees?
13. Is the bank's possession of all assets owned or managed in fiduciary capacities subjected to verification?
14. If the bank has automated systems, does the program call for the application of independently prepared computer programs that employ the computer as an audit tool?
15. Are all service-related activities not specifically manifested in general ledger accounts subject to adequate periodic review (e.g., supervisory regulations, security, vacation policy, purchases, traveler's checks, and safekeeping)?
16. Will appraisals of administrative control be made for each function, yielding audit comments and suggestions for improvements of operational efficiency?

AUDIT DEPARTMENT PARTICIPATION IN SYSTEMS DESIGN PROJECTS

1. Is there a formal or informal procedure for notifying the CAE of contemplated new systems or systems modifications in the early planning stages?
2. Is the CAE a member of an executive systems planning or steering committee? If not, does the CAE or a senior member of the audit department have access to and review the minutes of such committees?
3. Does an audit representative review the activities of systems design teams for audit and internal control requirements? Is the specialized training and experience of the audit staff sufficient to support effective reviews?
4. Does the audit department avoid overparticipation in systems design, modification, and conversion?
5. Is an auditor's "sign-off" on new or modified systems restricted to control and audit trail features?

AUDIT MANUAL

1. Has the responsibility for the establishment and maintenance of the audit manual been clearly assigned?
2. Does the audit manual require approval by the board of directors, the audit committee, or others? If so, has such approval been obtained?
3. Is the audit manual's content independent from adverse influence by other interests, such as operating management or independent CPAs?
4. Is the audit manual current, and are procedures for keeping the manual current adequate?
5. Does the manual provide for valid deviations from audit procedures to be officially approved by audit management?
6. Do audit procedures provide for the follow up of issues/findings noted in previous audits?
7. Does the manual prescribe that each audit procedure be cross-referenced to the appropriate audit workpapers?
8. Must an auditor initial each program step as testimony of his or her performance?

9. Does the manual prescribe that full control be established at the time of entry over the records selected for audit?
10. Are subsidiary direct verification programs covering all forms of customer deposit, loan, safekeeping, collateral, collection, and trust accounts included?
11. Are flow charts needed for evidence of thorough analytical auditing when an end-to-end audit is performed?
12. Do the procedures employ statistical sampling techniques that have acceptable reliability and precision when such techniques are appropriate for a specific area?
13. Does the audit manual contain provisions for report format and content and an expression of the opinion, such as an audit rating system, of the auditor regarding the adequacy, effectiveness, and efficiency of internal controls?
14. Does the audit manual contain a provision for a review and update of the procedures for each audit, where required, upon the audit's completion?
15. Does the audit manual provide for the maintenance of a permanent file for audits conducted?
16. Does the audit manual contain provisions for the formal, standardized preparation and maintenance of workpapers?
17. Are applicable statutory and regulatory requirements included in the audit procedures?

MAINTENANCE OF AUDIT RECORDS

1. If automated audit workpapers are not used, are workpapers arranged and maintained for filing and reference in the current file? The permanent file?
2. Is a reasonable record-retention schedule and departmental index maintained for audit records?
3. Are audit procedures being complied with during each audit?
4. Do the workpapers contain evidence that all significant deviations from standard audit procedures are being documented and have received the approval of audit management?
5. Are the procedures for preparing and maintaining workpapers adhered to?
6. Do workpapers adequately document the internal audit work performed and support the audit reports?
7. Do workpapers contain a copy of the audit report, an adequate index, an internal control questionnaire, audit procedures, and other appropriate material?
8. Are workpapers numbered, indexed, and cross-referenced to audit procedures and the workpapers index?
9. Is each workpaper dated and initialed by the preparer?
   a. Are sources of data clearly shown?
   b. Are tick marks explained?
10. From the workpapers, can it be determined how various sample sizes were determined (by judgment, statistical, or other methods of sampling), including the range and confidence level?
11. Do workpapers contain evidence that supervisory personnel of the audit department have reviewed the workpapers and resultant findings?
12. Are all significant or unresolved exceptions noted in workpapers required to be included in the report?
13. Are applicable statutory and regulatory requirements being complied with?

AUDIT DEPARTMENT'S FORMAL REPORTING PROCEDURES

1. Does the CAE issue formal reports? If so, to whom?
   a. Do the reports convey to the reader the auditor's general observation of the condition of the operation of the department or function? Do they adequately reflect the scope of the audit?
   b. Do they contain an opinion of the auditor regarding the adequacy, effectiveness, and efficiency of internal controls?
   c. Do they call for a prompt response, where appropriate?
2. With regard to audit exceptions and recommendations, is the method of resolving differences of opinion between audit and operating management effective?
3. Does the CAE maintain a formal record of all audit reports that contain unresolved recommendations and exceptions?
4. Does bank management promptly respond to significant identified internal control

weaknesses? Are exceptions and recommendations generally resolved within an appropriate timeframe agreed to by audit and the department?

5. Are audit reports issued in a timely manner?
6. Are management responses received timely?

QUALITY ASSURANCE

1. Does the audit department have an internal quality-assurance function? Does the function review a selected set of workpapers and the adequacy of other processes at least annually?
2. Does the function accumulate frequent errors and have sessions with audit to go over proper procedures?
3. For institutions in scope for SR-13-1/CA-13-1, has an external quality-assurance review been completed within at least the past five years in line with IIA recommendations?

USE AND EFFECTIVENESS OF AUDIT COMPUTER PROGRAMS

Note: This section would be applicable to smaller audit departments that only use a limited number of computer audit programs

1. What audit computer programs are used, and what are their purposes?
2. Is there a member of the audit staff qualified to write and appraise the quality of audit computer programs?
3. Is the auditor satisfied that he or she has sufficient "free access" to the computer files?
4. Are audit programs run on request?
5. Do direct verification programs allow the auditor flexibility in selecting the criteria to be used in determining the sample?
6. Have procedures been established for the development and maintenance of documentation for audit computer programs? Are they adhered to?
7. Are changes to audit programs controlled?

INTERNAL AUDIT OUTSOURCING ARRANGEMENTS

1. If the bank outsources its internal audit function—
   a. Does the bank have a written contract, which may take the form of an engagement letter, or a similar services agreement with the vendor?
   b. Does the audit committee maintain ownership of the internal audit function?
   c. Does the audit committee and the CAE provide active and effective oversight of outsourced activities?
   d. Does the audit committee approve all significant aspects of outsourcing arrangements and receive information on audit deficiencies in a manner consistent with that provided by the in-house audit department?
   e. Is the quality of audit work consistent with the institution's standards of work expected to be performed by the in-house audit department?
   f. Have internal audit vendors provided accurate reports on the control environment and any changes to enhance controls?
2. Does the written contract or engagement letter include provisions that—
   a. define the expectations and responsibilities under the contract for both parties;
   b. set the scope and frequency of, and the fees to be paid for, the work to be performed by the vendor;
   c. set the responsibilities for providing and receiving information, such as the type and frequency of reporting to senior management and directors about the status of contract work;
   d. establish the process for changing the terms of the service contract, especially for expansion of audit work if significant issues are found, and contain stipulations for default and termination of the contract;
   e. state that internal audit reports are the property of the institution, that the institution will be provided with any copies of the related workpapers it deems necessary, and that employees authorized by the institution will have reasonable and timely access to the workpapers prepared by the outsourcing vendor;

f. specify the locations of internal audit reports and the related workpapers;
g. specify the period of time (e.g., seven years) that vendors must maintain the workpapers;[2]
h. state that outsourced internal audit services provided by the vendor are subject to regulatory review and examiners will be granted full and timely access to the internal audit reports and related workpapers prepared by the outsourcing vendor;
i. prescribe a process (arbitration, mediation, or other means) for resolving disputes and for determining who bears the cost of consequential damages arising from errors, omissions, and negligence;
j. state that the outsourcing vendor will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of a member of management or an employee and, if applicable, will comply with AICPA, SEC, Public Company Accounting Oversight Board (PCAOB), or regulatory independence guidance; and
k. state that workpapers and any related non-public confidential information and personal information will be held in compliance with applicable laws and regulations?

3. Does the outsourced internal audit arrangement maintain or improve the quality of the internal audit function and the bank's internal control?
4. Do key employees of the bank and the outsourcing vendor clearly understand the lines of communication to and from the audit committee and senior management, and how any internal control problems or other matters noted by the outsourcing vendor are to be addressed?
5. Is the scope of the outsourced work revised appropriately when the bank's environment, structure, activities, risk exposures, or systems change significantly?
6. Have the directors ensured that the outsourced internal audit activities are effectively managed by the bank?
7. Does the arrangement with the outsourcing vendor satisfy the independence standards described in the Policy Statement on the Internal Audit Function and Its Outsourcing and thereby preserve the independence of the internal audit function?
8. Has the bank performed sufficient due diligence to satisfy itself of the vendor's competence before entering into the outsourcing arrangement, and are there adequate procedures for ensuring that the vendor maintains sufficient expertise to perform effectively throughout the arrangement?
9. Does the bank have a contingency plan to ensure continuity in audit coverage, especially for high-risk areas?

EXTERNAL AUDIT ENGAGEMENT LETTERS AND OTHER AUDIT AGREEMENTS

1. Does the bank's board of directors, audit committee, and senior management closely review all of the provisions in audit engagement letters or other audit work agreements before agreeing to sign them?
2. Does the bank's legal counsel carefully review audit engagement letters to ensure that those charged with engaging the external auditor make a fully informed decision?
3. Does the bank have any engagement letters for audits of financial statements, audits of internal control over financial reporting, or attestations on management's assessment of internal control that include unsafe and unsound provisions that—
   a. indemnify the external auditor against all claims made by third parties?
   b. hold harmless or release the external auditor from liability for claims or potential claims that might be asserted by the client financial institution (other than claims for punitive damages)?
   c. limit the remedies available to the client financial institution (other than punitive damages)?
4. Has the bank agreed in any engagement letters or other audit work agreements to submit disputes over external audit services to mandatory and binding alternative dispute resolution, binding arbitration, or other binding nonjudicial dispute-resolution processes (collectively, mandatory ADR) or to waive the right to a jury trial? If so—

2. If the workpapers are in electronic format, contracts often call for the vendor to maintain proprietary software that enables the bank and examiners to access the electronic workpapers for a specified time period.

a. has the bank's senior management carefully reviewed mandatory ADR and jury-trial provisions in engagement letters, as well as reviewed any agreements regarding rules of procedure, in order to fully comprehend the ramifications of any agreement to waive any available remedies?
b. has the bank's senior management obtained written assurances that its insurance policies (e.g., the bank's errors and omissions policies and directors' and officers' liability policies) will cover losses from claims that are precluded by limitation-of-liability provisions in audit engagement letters or other audit agreements?

5. Has the bank's senior management ensured that any mandatory ADR provisions in audit engagement letters are commercially reasonable and—
   a. apply equally to all parties;
   b. provide a fair process (e.g., neutral decisionmakers and appropriate hearing procedures); and
   c. are not imposed in a coercive manner?
6. Has the bank's board of directors, audit committee, or senior management documented their business rationale for agreeing to any provisions that limit their legal rights?

EXTERNAL AUDIT ACTIVITIES

1. When state, federal, or supervisory regulations or stock-exchange listing require an independent CPA audit, did the bank comply?
   a. If so, was the opinion rendered by the accounting firm unqualified?
   b. If not, has the CAE taken appropriate action to resolve any deficiencies?
2. Does the bank policy prohibit loans to its external auditor or the engagement of an external auditor who is a stockholder? If not, has the board considered the materiality of any existing transactions regarding the auditor's independence?
3. Has an external auditor been engaged to perform special reviews of specific departments or areas of the bank since the previous examination? If deficiencies were cited, have they been corrected?
4. Has the public accounting firm changed since the prior engagement? If so, obtain the rationale for change.
5. Have management letters from the external auditors or other reports from consultants been presented to management since the last examination?
6. Do deficiencies in management letters receive appropriate attention?
7. Are the notes pertaining to the financial statements reviewed for any information that may allude to significant accounting or control problems?
8. Does the management letter submitted by the public accounting firm comprehensively define the scope of the activities conducted?

REGULATORY EXAMINATION ACTIVITIES

1. Does the internal audit department have access to the examination reports?
2. Does the internal audit department review regulatory comments for comparison to similar work performed by audit to determine potential enhancements to existing work programs?
3. Does internal audit track status of corrective action to ensure timely remediation? If not, which department performs this function?

Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $50 Billion

Effective date May 2019

Section 1011.1

INTRODUCTION AND APPLICABILTY

This section conveys the supervisory guidance that is attached to SR letter 16-11, “Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $50 Billion.” The guidance in SR-16-11 applies to all supervised institutions with total consolidated assets less than $50 billion, which includes state member banks, bank holding companies, savings and loan holding companies (including insurance and commercial savings and loan holding companies), and foreign banking organizations (FBOs) with consolidated U.S. assets of less than $50 billion. SR 16-11 also applies to insurance and commercial savings and loan holding companies with total consolidated assets less than $50 billion by providing core risk management guidance.

OVERVIEW

Managing risks is fundamental to the business of banking. Accordingly, the Federal Reserve places significant supervisory emphasis on an institution’s management of risk, including its system of internal controls, when evaluating the overall effectiveness of an institution’s risk management. An institution’s failure to establish a management structure that adequately identifies, measures, monitors, and controls the risks of its activities has long been considered unsafe and unsound conduct. Principles of sound management should apply to the entire spectrum of risks facing an institution including, but not limited to, credit, market, liquidity, operational, compliance, and legal 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, including, but not limited to, interest rates, foreign exchange rates, commodity prices, or equity prices.
- *Liquidity risk* is the potential that a financial 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 (referred to as “market liquidity risk”).
- *Operational risk* is the risk resulting from inadequate or failed internal processes, people, and systems or from external events (this definition conforms to the Basel committee’s definition of operational risk).
- *Compliance risk* is the risk of regulatory sanctions, fines, penalties or losses resulting from failure to comply with laws, rules, regulations, or other supervisory requirements applicable to a financial institution.
- *Legal risk* is the potential that actions against the institution that result in unenforceable contracts, lawsuits, legal sanctions, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a financial institution.

These risks and the activities associated with them are addressed in greater detail in the Federal Reserve’s supervision manuals and other guidance documents.[1] In practice, an institution’s business activities present various combinations, concentrations, and interrelationships of these risks depending on the nature and scope of the particular activity. This section provides guidelines for supervisory assessment of the overall effectiveness of an institution’s risk management and its formal or informal systems for identifying, measuring, monitoring, and controlling these risks.

1. Refer to the Federal Reserve’s *Commercial Bank Examination Manual*, *Bank Holding Company Supervision Manual*, *Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations,* and relevant Federal Financial Institutions Examination Council Examination Manuals.

ELEMENTS OF RISK MANAGEMENT

As part of the risk management evaluation of overall management effectiveness at an institution, examiners should place primary consideration on findings relating to the following elements of a sound risk management system:

- board and senior management oversight[2]
- policies, procedures, and limits
- risk monitoring and management information systems
- internal controls

Each of these elements is described further, along with a list of considerations relevant to assessing 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 are not a checklist of requirements for each institution.

An institution's risk management processes are expected to evolve in sophistication, commensurate with the institution's asset growth, complexity, and risk. At a larger or more complex organization, the institution should have more sophisticated risk management processes that address the full range of risks regardless of where the activity is conducted in the organization. Moreover, while a holding company should be able to assess the major risks of the consolidated organization, examiners should expect a parent company that centrally manages the operations and functions of its subsidiary banks to have more comprehensive, detailed, and developed risk management systems than a parent company that delegates the management of risks to relatively autonomous subsidiaries.[3]

For a small community banking organization (CBO) engaged solely in traditional banking activities and whose senior management is actively involved in the details of day-to-day operations, relatively basic risk management systems may be adequate. In accordance with the *Interagency Guidelines Establishing Standards for Safety and Soundness*, a CBO is expected, at a minimum, to have internal controls, information systems, and internal audit that are appropriate for the size of the institution and the nature, scope, and risk of its activities.[4]

The risk management processes of a regional banking organization (RBO) would typically contain detailed guidelines that set specific prudent limits on the principal types of risks relevant to a RBO's consolidated activities. Furthermore, because of the diversity and the geographic dispersion of their activities, these institutions will require relatively more sophisticated information systems that provide management with timely information that supports the management of risks. The information systems, in turn, should provide management with information that present a consolidated and integrated view of risks that are relevant to the duties and responsibilities of individual managers, senior management, and the board of directors.[5]

Consistent with the principle of national treatment, the Federal Reserve has the same supervisory goals and standards for the U.S. operations of FBOs as for domestic organizations of similar size, scope, and complexity.[6] Given the added element of foreign ownership, an FBO's risk management processes and control functions for the U.S. operations may be implemented domestically or outside of the United States. In cases where these functions are performed outside of the United States, the FBO's oversight function, policies and procedures, and information systems need to be sufficiently transparent to allow U.S. supervisors to assess their

2. For the purpose of this guidance, for foreign banking organizations, "board of directors" refers to the equivalent governing body of the U.S. operations of the FBO.

3. If these subsidiaries are regulated by another federal banking agency, Federal Reserve examiners should rely on the conclusions drawn by relevant regulators regarding risk management to the fullest extent possible. See also, SR letter 16-4, "Relying on the Work of the Regulators of the Subsidiary Insured Depository Institution(s) of Bank. Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of Less than $50 Billion."

4. Refer to 12 CFR 208, Appendix D-1, the Interagency Guidelines Establishing Standards for Safety and Soundness.

5. On May 24, 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act (Pub. L. No. 115-174, 132 Stat. 1296 (2018)) amended the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. No. 111-203, 124 Stat. 1376 (2010)) as well as other statutes administered by the Board of Governors of the Federal Reserve System (Board). This includes aspects of the Board's Regulation YY discussing enhanced prudential standard requirements regarding risk management for holding companies. For more information, see the Board's July 6, 2018, "Statement regarding the impact of the EGRRCPA."

6. National treatment requires nondiscrimination between domestic and foreign firms, or treatment of foreign entities that is no less favorable than that accorded to domestic enterprises in like circumstances. The International Banking Act of 1978 generally gives foreign banks operating in the United States the same powers as domestic banking organizations and subjects them to the same restrictions and obligations.

adequacy. Additionally, the FBO's U.S. senior management need to demonstrate and maintain a thorough understanding of all relevant risks affecting the U.S. operations and the associated management information systems, used to manage and monitor these risks within the U.S. operations.

The information systems at a larger institution will naturally require frequent monitoring and testing by independent control areas, and by both internal and external auditors, to ensure the integrity of the information used by the board of directors and senior management in overseeing compliance with policies and limits. Therefore, an institution's risk oversight function needs to be sufficiently independent of the business lines to achieve an adequate separation of duties and the avoidance of conflicts of interest.

Board and Senior Management Oversight

The board of directors has the responsibility for establishing the level of risk that the institution should take. Accordingly, the board of directors should approve the institution's overall business strategies and significant policies, including those related to managing risks. Further, the board of directors should also ensure that senior management is fully capable of implementing the institution's business strategies and risk limits. In evaluating senior management, the board of directors should consider whether management is taking the steps necessary to identify, measure, monitor, and control these risks.

The board of directors should collectively have a balance of skills, knowledge, and experience to clearly understand the activities and risks to which the institution is exposed. The board of directors should take steps to develop an appropriate understanding of the risks the institution faces, through briefings from experts internal to their organization and potentially from external experts. The institution's management information systems should provide the board of directors with sufficient information to identify the size and significance of the risks. Using this knowledge and information, the board of directors should provide clear guidance regarding the level of exposures acceptable to the institution and oversee senior management's implementation of the procedures and controls necessary to comply with approved policies.

Senior management is responsible for implementing strategies set by the board of directors in a manner that controls risks and that complies with laws, rules, regulations, or other supervisory requirements on both a long-term and day-to-day basis. Accordingly, senior management should be fully involved in and possess sufficient knowledge of all activities 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 the need for effective risk management, internal controls, and high ethical business practices. To fulfill these responsibilities, senior management needs to have a thorough understanding of banking and financial market activities and detailed knowledge of the institution's activities, including the internal controls that are necessary to limit the related risks.

In assessing the quality of the oversight provided by the board of directors and senior management, examiners should consider the following:

- The board of directors has approved significant policies to establish risk tolerances for the institution's activities and periodically reviews risk exposure limits to align with changes in the institution's strategies, address new activities and products, and react to changes in the industry and market conditions.
- Senior management has identified and has a clear understanding and working knowledge of the risks inherent in the institution's activities. Senior management also remains informed about these risks as the institution's business activities evolve or expand and as changes and innovations occur in financial markets and risk management practices.
- Senior management has identified and reviewed risks associated with engaging in new activities or introducing new products to ensure that the necessary infrastructure and internal controls are in place to manage the related risks.
- Senior management has ensured that the institution's activities are managed and staffed by personnel with the knowledge, experience, and expertise consistent with the nature and scope of the institution's activities and risks.
- All levels of senior management provide appropriate management of the day-to-day activities of officers and employees, including oversight of senior officers or heads of business lines.

- Senior management has established and maintains effective information systems to identify, measure, monitor, and control the sources of risks to the institution.

Policies, Procedures, and Limits

Although an institution's board of directors approves an institution's overall business strategy and policy framework, senior management develops and implements the institution's risk management policies and procedures that address the types of risks arising from its activities. Once the risks are properly identified, the institution's policies and procedures should provide guidance for the day-to-day implementation of business strategies, including limits designed to prevent excessive and imprudent risks. An institution should have policies and procedures that address its significant activities and risks with the appropriate level of detail to address the type and complexity of the institution's operations. A smaller, less complex institution that has effective senior management directly involved in day-to-day operations would generally not be expected to have policies as sophisticated as larger institutions. In a larger institution, where senior managers rely on widely dispersed staffs to implement strategies for more varied and complex businesses, far more detailed policies and procedures would generally be expected. In either case, senior management is expected to ensure that policies and procedures address the institution's material areas of risk and that policies and procedures are modified when necessary to respond to significant changes in the institution's activities or business conditions.

The following guidelines should assist examiners in evaluating an institution'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 significant risk-taking activities.
- The policies, procedures, and limits are consistent with the institution's stated strategy and risk profile.
- The policies and procedures establish accountability and lines of authority across the institution's activities.
- The policies and procedures provide for the review and approval of new business lines, products, and activities, as well as material modifications to existing activities, services, and products, to ensure that the institution has the infrastructure necessary to identify, measure, monitor, and control associated risks before engaging in a new or modified business line, product, or activity.

Risk Monitoring and Management Information Systems

Institutions of all sizes are expected to have risk monitoring and management information systems in place that provide the board of directors and senior management with timely information and a clear understanding of the institution's business activities and risk exposures. The sophistication of risk monitoring and management information systems should be commensurate with the complexity and diversity of the institution's operations. Accordingly, a smaller and less complex institution may require less frequent management and board reports to support risk monitoring activities. For example, these reports may include, daily or weekly balance sheets and income statements, a watch list for potentially troubled loans, a report on past due loans, an interest rate risk report, and similar items. In contrast, a larger, more complex institution would be expected to have much more comprehensive reporting and monitoring systems, which includes more frequent reporting to board and senior management, tighter monitoring of high-risk activities, and the ability to aggregate risks on a fully consolidated basis across all business lines, legal entities, and activities.

In assessing 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, models, and procedures used in measuring and monitoring risks are appropriate and adequately documented and tested for reliability on an ongoing basis.[7]
- Reports and other forms of communication address the complexity and range of an institution's activities, monitor key exposures and compliance with established limits and strategy, and as appropriate, compare actual versus

7. See this manual's section "Model Risk Management," and SR letter 11-7, "Guidance on Model Risk Management."

expected performance.
- Reports to the board of directors and senior management are accurate, and provide timely and sufficient information to identify any adverse trends and to evaluate the level of risks faced by the institution.

Internal Controls

An effective internal control structure is critical to the safe and sound operation of an institution. Effective internal controls promote reliable financial and regulatory reporting, safeguard assets, and help to ensure compliance with relevant laws, rules, regulations, supervisory requirements, and institutional policies. Therefore, an institution's senior management is responsible for establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and the appropriate segregation of duties.

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

Internal controls should be tested by an independent party who reports either directly to the institution's board of directors or its designated committee, which is typically the audit committee.[8] However, small CBOs 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. Given the importance of appropriate internal controls to institutions 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 the findings. In addition, communication channels should allow for adverse or sensitive findings to be reported directly to the board of directors or to the relevant board committee.

In evaluating internal controls, 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 institution's activities.
- The institution's organizational structure establishes clear lines of authority and responsibility for risk management and for monitoring adherence to policies, procedures, and limits.
- Internal audit or other control functions, such as loan review and compliance, provide for independence and objectivity.
- The official organizational structures reflect actual operating practices and management responsibilities and authority over a particular business line or activity.
- Financial, operational, risk management, and regulatory reports are reliable, accurate, and timely; and wherever applicable, material exceptions are noted and promptly investigated or remediated.
- Policies and procedures for control functions support compliance with applicable laws, rules, regulations, or other supervisory requirements.
- Internal controls and information systems are adequately tested and reviewed; the coverage, procedures, findings, and responses to audits, regulatory examinations, and other 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 board of directors, or audit committee, and senior management are responsible for developing and implementing an effective system of internal controls and that the internal controls are operating effectively.

Conclusions

Examiners are expected to assess risk management for an institution and assign formal ratings of "risk management" as described in the *Com-*

8. Given the importance of the internal audit function, several additional policy statements have been issued. For comprehensive guidance on internal audit, see SR letter 03-5, "Amended Interagency Guidance on the Internal Audit Function and its Outsourcing" and for institutions with more than $10 billion in assets, see SR letter 13-1/ CA letter 13-1, "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing."

mercial Bank Examination Manual for state member banks, the *Bank Holding Company Manual* for bank holding companies and certain savings and loan holding companies, and the *Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations*.[9] In reports of examination or inspection, and in transmittal letters to the boards of directors of state member banks, holding companies, and to the FBO officer of the U.S. operations, examination staff should specifically reference the types and nature of corrective actions that need to be taken by an institution to address noted risk management and internal control deficiencies. Where appropriate, the Federal Reserve will advise an institution that supervisory action will be initiated, if the institution fails to timely remediate risk management weaknesses when such failures create the potential for serious losses or if material deficiencies or situations threaten its safety and soundness. Such supervisory actions may include formal enforcement actions against the institution, or its responsible officers and directors, or both, and would require the immediate implementation of all necessary corrective measures.

If bank or holding company subsidiaries are regulated by another federal banking agency, Federal Reserve examiners should rely to the fullest extent possible on the conclusions drawn by relevant regulators regarding risk management. See also, SR letter 16-4, "Relying on the Work of the Regulators of the Subsidiary Insured Depository Institution(s) of Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of Less than $50 Billion."

9. Refer to the section entitled, "Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System and the Federal Reserve's Risk Management Rating," of the *Commercial Bank Examination Manual*; the RFI Ratings section of the *Bank Holding Company Supervision Manual*; and the "Rating System for U.S. Branches and Agencies of Foreign Banking Organizations" section of the *Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations*. For relevant savings and loan holding companies, see the RFI Ratings section of the *Bank Holding Company Supervision Manual* and SR letter 14-9, "Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program."

Risk Management Processes and Internal Controls of Firms Having $50 Billion or More in Total Assets

Effective date May 2019

Section 1012.1

APPLICABILTY

The guidance in this section largely is based on SR letter 95-51, “Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies.” This risk management guidance applies to the supervision of state member banks and bank holding companies with greater than $50 billion in total consolidated assets.

SR letter 95-51 instituted an explicit risk management rating requirement to be assigned for examinations commencing on or after January 2, 1996. The risk management rating applies to all state member banks, regardless of their size. For more information on this risk management rating, see the appendix to this manual’s section entitled, “Condition of the Bank: Uniform Financial Institutions Rating System.”

INTRODUCTION

The Federal Reserve places significant supervisory emphasis on the adequacy of an institution’s management of risk, including its system of internal controls, when assessing the condition of an organization. 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 (referred to as “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 judgments 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.

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 the quality of bank management’s formal or informal systems for identifying, measuring, and containing these risks.

ELEMENTS OF RISK MANAGEMENT

When evaluating the quality of risk management 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, risk monitoring, and management information systems
- comprehensive internal controls

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 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 encompass the organization's trust and fiduciary activities, including investment advisory services, mutual funds, and securities lending.

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.

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.

When 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 they 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 to any changes in the institution's strategies, reviews new products, and reacts to changes in market conditions.
- Management ensures that its lines of business are managed and staffed by personnel whose knowledge, experience, and expertise is 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 soundly manage the institution's activities, and ensures that 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 new products, management identifies and reviews all risks associated with the activities or products and ensures that the infrastructure and internal controls necessary to manage the related risks are in place.

Adequate Policies, Procedures, and Limits

As previously stated, the board of directors is ultimately responsible for the level of risk taken by the institution. Senior management is responsible for implementing strategies in a manner that limits risks associated with each strategy. 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 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, 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.

Examiners should consider the following when 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 new activities to ensure that the financial institution has the necessary infrastructures to identify, monitor, and control risks associated with an activity before it 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.

When assessing the adequacy of an institution's risk measurement and monitoring, as well as 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 are tested for reliability on an ongoing 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 Controls

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.

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 generally should 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.

When 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 for the control areas are independent from the business lines, and there is adequate separation of duties throughout the organization—such as duties 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, and, when 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 of, procedures for, and 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 regularly.

The Risk Management Rating is to be reflected in the institution's overall "Management" rating. The risk management rating should be consistent with the stated rating criteria of "1" through "5." For more information see the appendix to the section entitled, "Condition of the Bank: Uniform Financial Institutions Rating System."

WHAT'S NEW IN THIS REVISED SECTION

Effective April 2017, this section is revised to include changes resulting from the November 16, 2016, issuance of SR-16-16 / CA-16-7, "Special Post-Employment Restriction for Senior Examiners." This letter was issued to announce an amendment to the Board's rule on Post-Employment Restrictions for Senior Examiners (12 CFR 264a), which expands the definition of "senior examiner." This amendment was developed to promote consistency in post-employment ethics rules across the Federal Reserve System and to address the risk associated with individuals leaving the Federal Reserve for employment with a regulated entity.

The Federal Reserve System (System) maintains a long-standing policy that compels System employees, including examiners, to avoid any action that may result in an employee (or create the appearance that an employee is)—

- using his or her Federal Reserve position for private gain,
- giving preferential treatment to any person or institution,
- losing independence or impartiality, or
- making decisions outside of official channels.

Federal Reserve examiners are also subject to conflict-of-interest rules that are designed to ensure (1) both the objectivity and integrity of bank examinations and (2) that Federal Reserve examiners comply with criminal statutory prohibitions.

The conflict-of-interest rules are set forth in section 5 of the *Federal Reserve Administrative Manual* (FRAM), which is a compilation of current Federal Reserve System operating policies and procedures issued by the Board of Governors, and in each Reserve Bank's uniform codes of conduct. In addition to providing guidance related to conflicts-of-interest rules, the FRAM provides comprehensive ethics-related guidelines pertaining to Federal Reserve supervisory staff such as:

- recusal from certain supervisory matters;
- borrowing prohibitions;
- prohibiting political communications with insured depository institutions or their affiliates; and
- post-employment restrictions.

PENALTY FOR VIOLATING EXAMINER BORROWING RULES

A bank examiner is prohibited from accepting a loan or gratuity from any bank examined by the individual (18 USC 213). An officer, director, or employee of a bank is prohibited from making or granting any loan or gratuity to any examiner who examines or has authority to examine the bank (18 USC 212). These statutory provisions may also be applicable to a loan obtained by a System employee who has been issued a special, temporary, or ad hoc examiner credential. Under section 213 of title 18 of the U.S. Code (Crimes), a bank examiner found in violation of the borrowing prohibition can be—

- fined under title 18 of the U.S. Code (Crimes), imprisoned not more than one year, or both;
- further fined a sum equal to the money loaned or gratuity given; and
- disqualified from holding office as an examiner.

POST-EMPLOYMENT RESTRICTIONS FOR "SENIOR EXAMINERS"

On November 17, 2005, the federal bank regulatory agencies[1] adopted a rule (effective December 17, 2005) to implement the post-employment restriction found in the Intelligence Reform and Terrorism Prevention Act of 2004 (see 12 USC 1820).[2] (See the Board's rules at 12 CFR 263, 264, 264a as well as SR-16-16 / CA-16-7, "Special Post-Employment Restriction for Senior Examiners," and its attachment.) The restriction prohibits an examiner who served as a "senior examiner" for a depository institution or depository institution holding company for two or more months during the examiner's final twelve

1. The Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.
2. Pub. L. 108-458, 118 Stat. 3638, 3751–53 (December 17, 2004).

months of employment with a Reserve Bank from knowingly accepting compensation as an employee, an officer, a director, or a consultant from that depository institution or holding company, or from certain related entities.[3] Table 1 summarizes how the restriction applies to "senior examiners" of the different types of organizations within the Federal Reserve's jurisdiction.

Definition of "Senior Examiner"

For purposes of this rule, an officer or employee of the Federal Reserve is considered to be the "senior examiner" for a particular depository institution or depository institution holding company[4] if the individual meets all of the following criteria:

- The officer or employee has been authorized by the Board to conduct examinations or inspections on behalf of the Board.
- The officer or employee has been assigned continuing, broad, and lead responsibility for examining or inspecting that depository institution or depository institution holding company.
- The officer's or employee's responsibilities for examining, inspecting, and supervising the depository institution or depository institution holding company—
  - represent a substantial portion of the officer's or employee's assigned responsibilities and
  - require the officer or employee to interact routinely with officers or employees of the depository institution or depository institution holding company.

This rule applies only to an individual serving in a leadership role who is dedicated to supervising a *single* depository institution (or group of affiliated depository institutions) or depository institution holding company. Specifically, the rule applies to senior supervisory officers (SSOs), deputy SSOs, enterprise risk officers (EROs),[5] central points of contact (CPCs), deputy CPCs, and supervisory team leaders.[6]

The rule does *not* cover an individual who

- is dedicated to supervising a single depository institution (or group of affiliated depository institutions) or depository institution holding company, but does not have leadership responsibilities in conjunction with this role;
- serves in a leadership role for *multiple* unaffiliated depository institutions or depository institution holding companies at the same time; or
- performs only periodic, short-term examinations of a depository institution or depository institution holding company, dedicating less than two months in a year to that institution.

Penalty for Violating "Senior Examiner" Restriction

The restriction applies to a covered individual for one year after the individual terminates his or her employment with the Reserve Bank. If an examiner violates the one-year restriction, the statute requires the appropriate federal banking agency to seek an order of removal and industry wide employment prohibition for up to five years, a civil money penalty of up to $250,000, or both. In special circumstances, the Chairman of the Board of Governors may waive the restriction for the "senior examiner" of the Federal Reserve by certifying in writing that granting the individual a waiver of the restric-

3. The Board's rule applies to a covered examiner who leaves the Federal Reserve's service after December 17, 2005. Because the statute has a one-year look-back provision, an examiner's responsibilities from as far back as December 17, 2004, may subject the ″senior examiner″ to the post-employment restriction.

4. This is applicable to financial market utilities (FMUs), and nonbank financial companies (NFCs) that are designated by the Financial Stability Oversight Council (FSOC) for supervision by the Federal Reserve, only to the extent that they are depository institutions or depository institution holding companies.

5. SSOs, Deputy SSOs, and EROs are job titles used by the Federal Reserve Bank of New York for senior officers serving on dedicated teams for Large Institution Supervision Coordinating Committee (LISCC) firms. For comparative purposes, the SSO job title is considered equivalent to the CPC job title, while the ERO job title is equivalent to the deputy SSO/CPC job title.

6. A supervisory team leader is defined as any Reserve Bank officer or employee who serves in a leadership role as part of a dedicated supervisory team. Examples of supervisory team leaders may include risk team leaders, business line team leaders, and the chief operating officers assigned to or supporting a dedicated supervisory team. The application of this rule is determined based on the roles and responsibilities of individuals rather than their specific job title. Questions regarding applicability and interpretation should be directed to the Board's Division of Supervision and Regulation conflicts staff.

tion would not affect the integrity of the Federal Reserve's supervisory program.

ADMINISTRATIVE PROCEDURES FOR IMPLEMENTING THE "SENIOR EXAMINER" RESTRICTION AND ADDITIONAL GUIDELINES

At a minimum, Reserve Banks shall adopt the following procedures to ensure that the "senior examiner" rule is properly implemented:

Notification to senior examiners

To help examiners comply with the statute, Reserve Banks shall establish procedures to periodically and regularly review examiners' duties and promptly notify examiners in writing when a change in duties would cause an examiner to be considered a "senior examiner" or cease to be considered a "senior examiner" with respect to an institution or holding company for purposes of the rule. Reserve Banks should consult with Board staff if questions arise as to whether an examiner would be considered a "senior examiner." The attachment to SR-16-16/CA-16-7 provides a sample form for a Notice of Post-Employment Restriction that Reserve Banks can use for such notification.

Examiners' responsibility

Examiners are responsible for becoming familiar with the rule and ensuring that they comply with the rule. Examiners should direct any questions they may have regarding the rule to the Reserve Bank's designated ethics officers.

Monitoring of senior examiner assignments

Reserve Banks shall maintain electronic records of examiners covered by the rule. These records at a minimum shall include

- the name of each "senior examiner";
- the name of the depository institution or depository institution holding company for which the examiner is considered a "senior examiner";
- the duration of the examiner's service as a "senior examiner" for the depository institution or depository institution holding company;
- the last date of Reserve Bank employment, as well as the reason for leaving, if the "senior examiner" ends employment with the Reserve Bank; and
- the name of the organization with which the senior examiner has accepted employment after ending employment with the Reserve Bank, if available.

Work Paper review

If any examiner, regardless of whether he or she is designated as a "senior examiner," accepts employment with a depository institution or depository institution holding company that he or she examined in the twelve months prior to his or her departure from Federal Reserve employment, the Reserve Bank shall review the work papers related to his or her assignment supervising that institution. The work paper review should be performed within 60 days of the examiner's departure and should consider whether the examiner compromised examination findings or supervisory proceedings because of pending employment with the relevant depository institution or depository institution holding company (for example, the examiner failed to bring significant findings or concerns forward to examination management, or omitted important examination processes or elements of the examination scope).

Disciplinary procedures

If a Reserve Bank becomes aware that a former examiner has violated the rule, the Reserve Bank shall promptly notify the Reserve Bank's officer-in-charge of supervision, its ethics officer, and the Board's designated agency ethics officer.

Table 1—Summary of Prohibited Employment Based on Examination Responsibility

Examiner Responsibility	*Restriction*
If during two or more months of the last twelve months of service, the examiner serves as the "senior examiner" for a—	Then for one year after leaving the Reserve Bank, the "senior examiner" may not knowingly accept compensation as an employee, officer, director, or consultant from—
State member bank	• the state member bank (including any subsidiary of the state member bank) or • any company (including a bank holding company) that controls the state member bank.
Bank holding company (BHC) or savings and loan holding company (SLHC)	• the BHC or SLHC • any depository institution controlled by the BHC or SLHC (including any subsidiary of the depository institution).
Foreign bank	• the foreign bank, • any U.S. branch or agency of the foreign bank, or • any U.S. depository institution controlled by the foreign bank (including any subsidiary of the depository institution).
Financial market utility (FMU)	• the FMU, but only if it is a depository institution or depository institution holding company, or • any entity controlled by the FMU, but only if the FMU is a depository institution holding company (including any subsidiary of the entity).
Nonbank financial company (NFC) that is designated by the Financial Stability Oversight Council (FSOC) for supervision by the Federal Reserve	• the NFC if it is a depository institution or depository institution holding company, or • any entity controlled by the NFC, but only if the NFC is a depository institution holding company (including any subsidiary of the institution).

INTRODUCTION

The Federal Reserve System (the System) deploys algorithms in regular monitoring to identify state member banks that (1) take on positions or pursue strategies that could lead to problem situations, (2) have a weak or declining financial condition, or (3) fail to comply with regulations. The surveillance systems rely on the Call Report, other regulatory reports, and examination data, as well as external data sources, to identify institutions exhibiting increased risk profiles, financial deterioration, or compliance shortfalls. The surveillance process promotes timely supervisory attention to these cases and directs examination resources to them.

System bank surveillance algorithms focus on many areas evaluated in the supervisory process, such as capital adequacy, liquidity, credit risk, market risk, and overall safety and soundness. In addition, screens flag banks engaging in new or complex activities. The algorithmic system's main components are the Outlier List, Watch List, State Member Bank Monitoring Screen, and Intercompany Transactions Exception List, as implemented in SR-15-16, "Enhancements to the Federal Reserve System's Surveillance Program," December 10, 2015, and described below. The surveillance information helps identify weak or deteriorating banks and those with changing risk profiles or deviations from supervisory expectations.

In addition to regular monitoring, supervisory staff also use surveillance results in pre-examination planning. Before an on-site review, the examiner will determine a bank's status on the System's Outlier List, Watch List, State Member Bank Monitoring Screen, and Intercompany Transactions Exception List. This information is useful in determining the type of examination to be performed (full or targeted), its scope and intensity, and the staff resources needed. The surveillance results are used to identify bank activities that may warrant a higher degree of review or focus during an on-site examination. In this manner, surveillance information helps examiners and other supervisory staff plan and schedule more forward-looking, risk-focused examinations.

Bank Surveillance Program activities generally consist of the following three phases:

1. In the first phase, data are processed by the algorithms, ranging from simple rules to financial models and machine learning results. When the algorithms detect departures from expected patterns involving banks, the results are transmitted via Performance Report Information and Surveillance Monitoring (PRISM), a web application available to Federal Reserve examiners and other supervisory staff for interactive data analysis.
2. The second phase begins as supervisory staff use additional tools and data to solidify the initial impressions presented by first-phase surveillance results. Key examples are the Focus Report—a web application available to Federal Reserve examiners and other supervisory staff for interactive risk assessment—and the Uniform Bank Performance Report. In addition, aggregate data views and reports of financial condition at the supervisory portfolio and industry levels can help place a particular bank's status in context.
3. The third phase involves the development of supervisory responses to the information generated in the first two steps. A primary goal is to focus supervisory resources on excessive risk-taking, the risk of emerging financial difficulties, and potential compliance shortcomings. Possible actions include intensification of an on-site review or acceleration of its scheduling. When problems are identified, follow-up by examiners promotes correction and resolution. By also identifying low-risk situations, the Bank Surveillance Program promotes the application of more streamlined supervisory approaches for such cases.

OUTLIER LIST

An Outlier List highlights state member banks with elevated risk-taking and identifies those with expanded or new areas of risk-taking. It is supported by "Outlier Metrics" in the form of algorithms generating risk classifications of low, moderate, or high for individual risk and performance dimensions. The Outlier List includes banks categorized as high risk within at least one risk or performance dimension. The risk identification algorithms can be based on a broad range of approaches and may evolve over time.

Examiners and other supervisory staff should use the Outlier List to monitor risk-taking and promote adequate risk management and mitigation, with the goal of bolstering banks' capacity to prevent or buffer financial losses. However, no regular write-up or documentation requirement is tied to the Outlier List.

The Outlier Metrics also assist examiners and other supervisory staff in determining the scope of a safety-and-soundness examination. The Outlier Metrics' role in pre-examination planning is particularly strong at community and regional state member banks, where a subset of the Outlier Metrics is implemented as in SR-19-9, "Bank Exams Tailored to Risk (BETR)," June 3, 2019. BETR's Outlier Metrics combine with examiner judgment to classify the levels of risk at a state member bank within individual risk dimensions, such as credit, liquidity, and operational risk. The bank's examination is then tailored to reflect the levels of risk present and minimize regulatory burden for the bank.

BETR's primary objectives are the following:

1. Identify a state member bank's activities that are low risk and apply appropriately streamlined examination work programs to those areas, thereby conserving supervisory staff resources.
2. Identify a state member bank's high-risk activities and target them for enhanced supervisory attention, thereby directing supervisory resources to where they are most needed.
3. For the remaining moderate-risk activities, implement examination work programs of average intensity.

BETR's Outlier Metrics gauge the potential for a state member bank to experience adverse outcomes, such as highly unfavorable financial trends, significant performance shortfalls, severe losses, or supervisory rating downgrades, over a 12- to 24-month timeframe, and under unfavorable market conditions. As such, the metrics assist examiners in classifying the levels of risk related to a bank's activities.

For each risk dimension considered by BETR, the Outlier Metrics classify the corresponding activity of a state member bank. Low-risk activities pose the least potential for adverse outcomes to a bank, while high-risk activities entail the greatest chance of unfavorable results. The following definitions generally apply:

- *High risk:* Under unfavorable market conditions, such activities often lead to adverse outcomes.
- *Moderate risk:* In unfavorable markets, these activities occasionally result in adverse outcomes.
- *Low risk:* The expected incidence of adverse outcomes is low, irrespective of market conditions.

The design features of the Outlier Metrics used in BETR are as follows:

1. *Data-driven:* The information content, or predictive capacity, of the metrics is confirmed via data analysis. This feature involves the estimation and back-testing of the metrics using data from previous banking cycles.
2. *Forward-looking:* The metrics gauge the risk posture of a state member bank and its susceptibility to severe losses or substantial underperformance. This feature is supported by estimating the relationship between risk indicators at a given point in time and bank performance a year or two later, particularly under unfavorable market conditions.
3. *Granular:* The metrics provide insight into individual risk dimensions. This feature is incorporated by developing the metrics separately for each risk dimension considered.

Outlier Metrics provide examiners with a data-driven starting point for determining the scope of a state member bank's examination. In cases where examiners are aware of factors indicating that an alternative risk classification for a particular risk dimension would be more appropriate, they should exercise supervisory judgment and adjust the risk tier during the scoping process. Examiners should then record their rationale in appropriate work papers and plan the examination work program accordingly.

BETR's Outlier Metrics should be used to allocate more examiner resources to review high-risk situations, while conserving resources in lower risk cases. The examiner should exercise prudent supervisory judgment and consider an institution's Outlier List status and all other applicable information, including the Watch List, State Member Bank Monitoring Screen, Intercompany Transactions Exception List, and previous examination results, when determining the scope and nature of the examination work required.

When the Outlier Metrics and other applicable information indicate a specific risk is high, the examiner generally should apply the fullest force of supervisory resources. Conversely, when the Outlier Metrics and other applicable information indicate a specific risk is moderate, and especially when risk is low, the examiner may be able to complete a smaller set of procedures. However, if during the course of an examination indications point to higher risk than anticipated or significant weaknesses in risk management, the examiner is expected to increase the examination's intensity or expand its scope, as needed.

WATCH LIST

The Watch List is a primary means for monitoring state member bank performance and condition between on-site examinations. It identifies the risk of emerging financial weaknesses among banks and includes all state member banks with composite safety-and-soundness ratings consistent with financial viability, but surveillance grades of "D" or "F," pointing to the possibility of deterioration in examination findings going forward.

To generate the surveillance grades, the Supervision and Regulation Statistical Assessment of Bank Risk (SR-SABR) early-warning model is applied to financial and supervisory information for each bank. The SR-SABR rating consists of the composite rating most recently assigned to a bank via the examination process, coupled with a surveillance letter grade (A, B, C, D, or F) reflecting the bank's estimated financial condition relative to others in the same rating class.[1]

SR-SABR ratings are designed for use both in monitoring and in determining the scope of an examination. An accompanying Schedule of Risk Factors (SRF) highlights specific indicators leading the model to flag a particular bank as strong or weak. Through ongoing monitoring, examiners and other supervisory staff review each state member bank on the Watch List to assess its financial condition and discern whether substantial deterioration is evident or impending. In such cases, they determine whether an examination or other supervisory initiative might be needed. The Watch List, much like the Outlier List and its metrics, can also be used in pre-examination planning to target potentially deteriorating situations for the most extensive reviews.

At times, Reserve Bank staff may need to produce supporting documentation to explain the reasons for a bank's placement on the Watch List and outline the appropriate supervisory response. For banks other than community banks, this type of information is often already contained in quarterly supervisory write-ups outside of the Watch List process. Separate surveillance write-ups are required for community banks on the Watch List when any of the following criteria are met:

1. The current SR-SABR rating is worse than the prior quarter; or
2. The SR-SABR rating is the same as the prior quarter, but the SRF identifies one or more new contributing factors; or
3. The most recent requirement for a write-up occurred four quarters earlier.

The assessments and conclusions comprising a write-up should be brief and supported by analysis. A Watch List write-up should

1. Summarize the factors leading to Watch List placement;
2. Describe any response from the bank to those factors;
3. Assess the likelihood of further financial deterioration;
4. Judge whether assigned safety-and-soundness ratings are accurate; and
5. Determine whether the timing of the next examination should be accelerated.

Corrective action associated with newly identified problems must be initiated promptly by Reserve Banks. Follow-up action may include correspondence or meetings with a bank's management or an on-site examination. Problem situations should be closely monitored by supervisory staff until they have been corrected or otherwise resolved.

1. In the model, banks with satisfactory composite ratings are grouped together into a single rating class. An SR-SABR grade of "A" denotes a bank with strong indicators relative to others in the same rating class, while an "F" indicates major weaknesses. Two grades are assigned to each bank, one reflecting the estimated probability of a downgrade to a worse rating class (Adverse Change grade) and another reflecting the estimated probability of critical undercapitalization or failure (Viability grade). The overall SR-SABR rating is based on the worse of the two grades.

STATE MEMBER BANK MONITORING SCREEN

The State Member Bank Monitoring Screen identifies complex activities, monitors compliance with regulations, and more generally can be used to detect novelties or departures from expected patterns. The monitoring screen identifies banks that have failed key screening criteria. The screening criteria are updated periodically and change over time. Examiners and other supervisory staff review State Member Bank Monitoring Screen results quarterly and follow up with supervisory initiatives when appropriate.

INTERCOMPANY TRANSACTIONS EXCEPTION LIST

The Intercompany Transactions Exception List helps track compliance with section 23A of the Federal Reserve Act;[2] it is a specialized monitoring process utilizing data from the FR Y-8, together with information from the Call Report.

For each depository institution possibly exceeding section 23A limits, supervisory staff perform the following: (1) follow up with the holding company submitting the FR Y-8 to verify the data are accurate; (2) if an error caused the exception, require an amended report; and (3) if the data are correct, and a depository institution appears to have had covered transactions exceeding section 23A limits, determine the nature and extent of the apparent violation. Reserve Bank staff produce a written review of their findings for each depository institution on the list. The review addresses any apparent violations or reporting errors, along with any corrective action taken.

2. See also the Board's Regulation W at 12 CFR 223.

1. To identify major changes in the risk posture of the bank between examinations.
2. To identify major changes in the financial condition of the bank between examinations.
3. To assist in determining the scope of the examination and the priority of work to be performed.
4. To check the validity of the data being reported by the bank.
5. To investigate areas where attention or an in-depth review is indicated.

1. Obtain any surveillance results, such as the Outlier List, Watch List, State Member Bank Monitoring Screen, and Intercompany Transactions Exception List, together with any other reports or analyses prepared by the Reserve Bank or Board, that have been generated for the bank.
2. Review the information obtained in step 1, and if necessary for clarification discuss those findings with surveillance staff.
3. Conduct a pre-examination analysis using the information from steps 1 and 2, together with the current Call Report, Uniform Bank Performance Report, prior examination report, and any other applicable information. This analysis should be considered when determining the scope of the examination and when making staffing decisions.
4. Follow up on any unusual aspects of the surveillance information, other reports and analyses, and newly obtained data.
5. Perform validity checks necessary to ensure the quality of reported data. This would include such normal examination procedures as validating Call Report information and confirming the accuracy and soundness of accounting practices.

INTRODUCTION

Workpapers are the written documentation of the procedures followed and the conclusions reached during the examination of a bank. Accordingly, they include, but are not necessarily limited to, examination procedures and verifications, memoranda, schedules, questionnaires, checklists, abstracts of bank documents and analyses prepared or obtained by examiners.

The definition of workpapers, their purpose, and their quality and organization are important because the workpapers as a whole should support the information and conclusions contained in the related report of examination. The primary purposes of workpapers are to—

- organize the material assembled during an examination to facilitate review and future reference.
- aid the examiner in efficiently conducting the examination.
- document the policies, practices, procedures and internal controls of the bank.
- provide written support of the examination and audit procedures performed during the examination.
- document the results of testing and formalize the examiner's conclusions.
- substantiate the assertions of fact or opinion contained in the report of examination.

They also are useful as—

- a tool for the examiner-in-charge to use in planning, directing, and coordinating the work of the assistants.
- a means of evaluating the quality of the work performed.
- a guide in estimating future personnel and time requirements.
- a record of the procedures used by the bank to assemble data for reports to the Board of Governors of the Federal Reserve System.
- a guide to assist in the direction of subsequent examinations, inquiries and studies.

The initial step in preparing workpapers is to review, where available, the applicable sections of supporting data prepared during the prior examination. When reviewing prior workpapers, the examiner should consider the data prepared in each area for—

- information that is of a continuing or permanent nature.
- guidance in preparation of workpapers for the current examination.
- an indication of changes or inconsistencies in accounting procedures or methods of their application since the last examination.

Accumulation of relevant documentation consistent with prior examinations, however, is often insufficient. Workpapers should be prepared in a manner designed to facilitate an objective review, should be organized to support an examiner's current findings and should document the scope of the current examination. Minimum content necessary for each section of workpapers includes:

Source of Information—This is important, not only in identifying the bank, but also in identifying the preparer. In subsequent examinations, the preparer should be able to readily determine the bank personnel from whom the information was obtained during the previous examination as well as the examiner who prepared the workpapers. Accordingly, each workpaper should include—

- bank name and subdivision thereof, either functional or financial.
- statement of title or purpose of the specific analysis or schedule.
- specific identification of dates, examination date and work performance date.
- initials of preparer and initials indicating review by the examiner designated to perform that function. Although appropriate use may be made of initials, the full names and initials of all examiners should appear on a time and planning summary or on an attachment to the file to facilitate future identification.
- name and title of person, or description of records, that provided the information needed to complete the workpaper.
- an index number identifying the workpaper and facilitating organization of the workpaper files.

Scope of Work—This includes an indication of the nature, timing and extent of testing in application of examination and audit procedures. It also includes the examiner's evaluation of and reliance on internal and external audit procedures and compliance testing of internal controls. To the extent that this information is contained in other workpapers, such as an examination procedure or a questionnaire, a reference to the appropriate workpaper will be sufficient.

Conclusions—The examiner should develop conclusions, in accordance with the examination objectives, with respect to the information obtained, documentation provided and the results of the examination and audit procedures performed. Such conclusions provide the basis for information contained in the report of examination.

To develop workpapers that have the qualities of clarity, completeness and conciseness, adequate planning and organization of content are essential. Therefore, before the workpaper is prepared, the examiner should determine the following:

- What examination objective will be satisfied by preparing the analysis or workpaper?
- Can preparation of the analysis be avoided by testing the bank's records and indicating the nature and extent of testing in an examination or an audit procedure or by comment on a related schedule or another supporting document?
- Is the analysis necessary to support the information in the report of examination?

Subsequent to the determination that an analysis is required, but before initiating preparation, the examiner should decide if—

- previous examination analyses can be adapted and carried forward to the current examination.
- the analysis can be prepared by an internal auditor or other bank personnel.
- the format of the analysis may be designed in a manner to facilitate its use in future examinations.

Once it has been determined that preparation of an analysis is required, the examiner should consider the following techniques that promote clarity of workpaper preparation:

- Restrict writing to only one side of the paper.
- Use a standard size sheet of paper large enough to avoid overcrowding.
- Condense information for simplicity.

Frequently, time can be saved by carrying forward workpapers from one examination to the next. Thus, when laying out an analysis that might be repeated in future examinations, the examiner should arrange it in a manner to facilitate future use. For example, extra columns may be left blank within an account analysis displaying little activity for insertion of transaction information during future examinations. In such a situation, appropriate space (boxes and column headings) should be provided for the signature or initials of the preparer and reviewer during each examination. When a workpaper is removed from one examination file and carried forward, a notation should be made in the file from which the paper is extracted. This is important in the event workpapers applicable to a particular examination are needed several years after the completion of the examination.

INITIAL PREPARATION BY OTHERS

Although all items included in the report of examination should be supported by workpapers, their preparation may not always require original work by the examiner. Frequently, arrangements can be made for bank personnel, including internal auditors, to prepare workpapers for examination use or to make available papers prepared by them as part of their regular duties. Examples include outstanding checklists, lists of outstanding certificates of deposit, schedules of employee borrowings, and debt maturity schedules. The extent to which examiners can utilize analyses and data prepared by bank personnel increases the efficiency with which examination procedures are completed.

As part of the initial examination planning process, arrangements should be made with appropriate bank management for the timely completion of bank-prepared data and information. The coordinating bank officer(s) must understand what information is being requested and why it is being requested, in order to avoid confusion and unnecessary regulatory burden. Arrangements, however, may have to be made for the bank to supply supporting details or other schedules or items to comply with the requests.

Upon receipt of bank-prepared analyses, an examiner should review the documents for overall completeness and note the date of receipt. This facilitates future planning and provides a ready reference as to which analyses have been received from the bank at any given point during the examination. Also, all bank-prepared workpapers should be tested and the nature and extent of testing performed by the examiner should be indicated on the papers.

INITIAL APPROACH IN WORKPAPER PREPARATION

The initial approach in preparing workpapers that support balances in the statement of condition is quantitative. In using this approach, the examiner obtains an analysis of the composition of the account balance as of the examination date. This inventory of the composition may be represented by a trial balance of loans, a listing of outstanding official checks, a listing of individual deposit accounts, or other similar items. Only after determining the composition and insuring that the total agrees with the bank's records is the examiner in a position to perform examination procedures and to arrive at a conclusion about the overall quality of the items comprising the balance.

For certain analyses, however, it is preferable to include account activity (transactions) in the workpapers. Typical examples of such analyses are those of bank premises and equipment and of reserve for possible loan losses. The format for reserve for possible loan losses should include beginning balances (prior examination ending balances), provisions for loan losses, collections, charge-offs, other transactions (transfers to/from undivided profits) and ending balances as of the examination date.

CONTROL AND REVIEW

All examiners assigned to an examination should insure that workpapers are controlled at all times while the examination is in progress. For example, when in the bank's offices, the workpapers should be secured at night and safeguarded during the lunch hour or at other times when no examining personnel are present in the immediate vicinity. It is essential to completely control confidential information provided by the bank. In addition, information relating to the extent of tests and similar details of examination procedures should not be made available to bank employees.

In cases where customary examination practices are not practical, alternative procedures and the extent to which they are applied should be documented. The need for completeness requires that there be no open items, unfinished operations or unanswered questions in the workpapers at the conclusion of the examination.

The clarity of workpapers should be such that an examiner or Federal Reserve official unfamiliar with the work could readily understand it. Handwritten commentaries should be legible, concise and should support the examiner's conclusions. Descriptions of work done, notations of conferences with bankers, conclusions reached and explanations of symbols used should be free from ambiguity or obscurity. Excessive use of symbols usually can be avoided by expanding a comment to include the nature and extent of work performed instead of using separate symbols for each portion of the work performed. In addition, instructions to assisting personnel concerning standards or workpaper content are necessary to ensure that they will meet the quality standards of the Federal Reserve. When workpapers have the necessary qualities of completeness, clarity, conciseness and neatness, a qualified reviewer may easily determine their relative value in support of conclusions and objectives reached. Incomplete, unclear or vague workpapers should, and usually will, lead a reviewer to the conclusion that the examination has not been adequately performed.

REVIEW PROCEDURES

Experienced personnel must review all workpapers prepared during an examination. Usually that review is performed by the examiner-in-charge, although in some cases, the examiner-in-charge may designate other experienced personnel to perform an initial review. An overall review is then performed by the examiner-in-charge. The two primary purposes of a review of workpapers by senior personnel are to determine that the work is adequate given the circumstances, and to ensure that the record is sufficient to support the conclusions reached in the report of examination. The timely review of workpapers and subsequent discussion of them with the individual who prepared them also is one of the more effective procedures for on-the-job training.

Normally, the review should be performed as soon as practicable after the completion of each work area. This review ideally occurs at the bank's office so that if the need for obtaining additional information arises or additional work is required the matter can be promptly attended to with minimum loss of efficiency.

When the review of workpapers is completed, the reviewer should sign or initial the applicable documents. Although all workpapers should be reviewed, the depth and degree of detail depends on factors such as:

- The nature of the work and its relative importance to the overall examination objectives.
- The extent to which the reviewer has been associated with the area during the examination.
- The experience of the examiners who have carried out the various operations.

Professional judgment must be exercised throughout the review process.

ORGANIZATION OF WORKPAPER FILES

Administration of an examination includes—

- organizing the workpaper files.
- delegating authority for completion of all applicable workpaper sections.
- reviewing and assembling the completed workpapers.

To ensure efficiency in locating information contained in the workpapers and completion of all necessary procedures, workpapers should be filed and indexed in a standard manner.

FILES

The file provides the organizational vehicle to assemble workpapers applicable to specific areas of the examination. Files might include detailed workpapers related to—

- management appraisal.
- overall conclusions about the condition of the bank.
- cash accounts.
- investments.
- loans.
- reserve for possible loan losses.
- bank premises and equipment.
- other assets.
- deposits.
- other liabilities.
- capital accounts and dividends.

Each individual file would normally include—

- related examination and audit procedures.
- detailed information and other documentation necessary to indicate the specific procedures performed, the extent of such procedures and the examiner's conclusions for the specific area.
- a summary, in comparative form, of the supporting general ledger balances with appropriate cross-references.

Judgment is required as to what the file should include on any specific examination. Lengthy documents should be summarized or highlighted (underlined) so that the examiner who is performing the work in the related area can readily locate the important provisions, without having to read the entire document. It also may be desirable to have a complete copy of the document in the file to support the summaries or answer questions of a specific legal nature.

Examples of documents that might be contained in the files are—

- a brief history and organization of the bank.
- organization charts of applicable departments within the bank.
- copies of, or excerpts from, the charter and bylaws.
- copies of capital stock certificates, debentures agreements and lease agreements.
- excerpts from minutes or contracts that are of interest beyond the current year.
- a chart of accounts and an accounting manual, if available, supplemented by descriptions of unique accounts and unusual accounting methods.
- lists of names and titles of the board of directors, important committees and relevant departmental personnel.

Indexing and Cross-Referencing

To promote efficiency and help ensure that all applicable areas of an examination have been considered and documented, the use of an indexing system aids in the organization of workpaper files. A general outline or index including all examination areas provides a basis for organization to which a numbering or other sequential system can be assigned and applied to each workpaper file.

When all workpapers pertinent to a specific area of the examination have been completed, a cover sheet listing the contents of each file should be attached to the front to provide a permanent record for reference. This permits not only efficient location of a set of workpapers pertinent to a specific area of the examination (for example, cash or commercial loans), but also facilitates the location of a specific analysis (or other document) within the set.

Amounts or other pertinent information appearing in more than one place in the workpapers should be cross-referenced between the analyses. A notation on the index, including appropriate cross-referencing of those items removed or filed elsewhere, facilitates location of specific data and records and also helps to prevent inadvertent loss of documents. An example is the cross-referencing of net charge-offs obtained in the review of the reserve for possible loan losses to the amount approved in the board of director's minutes. Proper cross-referencing is important because it—

- serves as a means of locating work performed for a particular account or group of accounts.
- identifies the source of supporting amounts in a particular analysis.
- facilitates the review of the workpapers.
- helps in following the workpapers during the succeeding examination.

WORKPAPER RETENTION

Examiners should retain on a readily available basis those workpapers from—

- the most recent full-scope Federal Reserve examination.
- the most recent general EDP examination.
- examinations of banks requiring or recommended for more than normal or special supervisory attention (composite rating of 3, 4 or 5; consumer compliance rating of 3, 4 or 5; EDP departments rated 4 or 5; or those subject to administrative action such as civil money penalties) until such banks are no longer the subject of such scrutiny.
- examinations disclosing conditions that may lead eventually to more than normal or special supervisory attention, as described above, until the supporting workpapers are no longer appropriate.
- examinations disclosing conditions that lead, or may eventually lead, to a criminal referral or criminal investigation.

These guidelines are the minimum required retention period for workpapers; longer retention periods may be set by individual Reserve Banks.