

## 1000—SUPERVISORY PROCESS

---

The 1000 series of sections explain the Federal Reserve's methodology for supervising state member banks of various asset sizes. These sections describe how examiners assess the safety and soundness of state member banks

using the Uniform Financial Institution Rating System or CAMELS (Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk) rating system.

### 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<sup>1</sup> (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.<sup>2</sup> 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.<sup>3</sup> 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.<sup>4</sup>

### CONFIDENTIALITY PROVISIONS

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

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.

1. 12 U.S.C. 1831p-1.

2. See 12 CFR 208, appendix D-1.

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.<sup>5</sup> 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.”<sup>6</sup>

## 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

6. See also this manual’s section, “Overall Conclusions Regarding Condition of the Bank.”

5. 12 CFR 261.20(g).

- 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 instru-

ments 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.<sup>7</sup> 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 sec-

tion 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<sup>8</sup> by establishing a de novo branch at any location at which a bank chartered by the host state could establish a branch.<sup>9</sup>

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).)

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.

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.

## 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.<sup>10</sup> 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).<sup>11</sup> 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<sup>12</sup> is compared with the host-state

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.

loan-to-deposit ratio<sup>13</sup> 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.<sup>14</sup>

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

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-to-day 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.<sup>15</sup>

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

<sup>15</sup> 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 Sys-

tems, Municipal Security Dealers, Transfer Agent, and Trust.<sup>16</sup>

## 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;<sup>17</sup>
- were assigned a CAMELS composite rating of “1” or “2” as part of the bank’s rating;<sup>18</sup>
- 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.<sup>19</sup>

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.<sup>20</sup> 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<sup>1</sup>

<i>Total Asset Size of the State Member Bank (SMB)<sup>2</sup></i>	<i>Composite CAMELS rating of “1” or “2” from the last examination</i>	<i>Composite CAMELS rating of “3” from the last examination</i>	<i>Composite CAMELS rating of “4” or “5” from the last examination</i>
\$0 to less than \$3 billion	<p>Full-scope on-site exam every 18 months, provided:</p> <ul style="list-style-type: none"> <li>SMB is well capitalized;</li> <li>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;</li> <li>SMB not subject to a formal enforcement proceeding or order by Federal Reserve or FDIC; and</li> <li>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.</li> </ul> <p>Otherwise, full-scope on-site exam every 12 months.</p> <p>May be eligible for alternate-year examination program (AEP).<sup>3</sup></p>	<p>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.<sup>4</sup></p>	<p>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.</p>
\$3–\$10 billion	<p>Full-scope on-site exam every 12 months. May be eligible for AEP.</p>		
Greater than \$10 billion and less than \$100 billion	<p>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.</p>		
\$100 billion and above	<p>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.</p>		

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.”<sup>21</sup>

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,<sup>22</sup> plus the additional safety-and-soundness and consumer compliance criteria listed below (together referred to as “eligibility criteria”).<sup>23</sup> 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).<sup>24</sup>

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<sup>25</sup>
- 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<sup>26</sup>
- 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."<sup>27</sup> 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.

### *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 poli-

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.

cies 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.<sup>28</sup>

## 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

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.

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.<sup>29</sup> 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"

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.<sup>30</sup> 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.”)

---

<sup>30</sup> 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.<sup>31</sup>

### 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.<sup>32</sup>

### *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-

<sup>32</sup>. 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<sup>33</sup> 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<sup>34</sup> 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 (MRIs) 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 MRIs and MRAs in all supervisory documents communicating supervisory findings.<sup>35</sup> When included in a safety-and-soundness examination or inspection report, MRIs and MRAs should be listed in the "Matters Requiring Attention" section. In the case of findings from consumer compliance examinations, MRIs and MRAs should be reflected in the "Executive Summary and Examination Ratings" section of the consumer

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.

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.

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 inac-

tion 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.<sup>36</sup> 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...”

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.

*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.<sup>37</sup>

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 MRIs 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 MRIs 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 MRIs 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 MRIs 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.<sup>38</sup> In addition to the guidance presented in SR-13-13/CA-13-10, ex-

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.

aminers 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;<sup>39</sup>
- whether the issues involve unsafe or unsound practices, violations of laws, noncompliance with regulations, insider abuse, fraud, or other material deficiencies;<sup>40</sup>
- 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.<sup>41</sup> 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

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.<sup>42</sup>

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 commu-

nication 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 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.

<i>Steps</i>	<i>Products</i>
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.<sup>1</sup> 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.<sup>2</sup>
- *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 examina-

tion 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.<sup>3</sup> 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 cer-

tain 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.

## 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

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

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 head-

ings 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<sup>4</sup>

#### *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.<sup>5</sup> 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 that 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 MRIs and MRAs. A detailed assessment of each prior MRI 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 MRIs and MRAs should be included as a footnote on this page. When issuing a supervisory finding (including through the issuance of an MRI 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 inter-agency 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 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.

The following is an example of the Risk Assessment Matrix:

#### Risk Assessment Matrix

<i>Type of risk</i>	<i>Inherent risk</i>	<i>Adequacy of risk management</i>	<i>Composite risk</i>	<i>Trend</i>
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;<sup>6</sup> (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.*<sup>7</sup> 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.*<sup>8</sup> 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.<sup>9</sup> 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.<sup>10</sup> 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).<sup>11</sup>

- 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."<sup>12</sup>

### *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.<sup>13</sup>

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."<sup>14</sup> 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.<sup>15</sup> 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.<sup>16</sup> 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),<sup>17</sup> 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.

---

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](#).

---

15. Bank and savings and loan holding companies with

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.<sup>18</sup> 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 au-

ditors 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**


---

	<i>Page</i>
Scope	23
Summary of Examination Ratings	24
Examination Conclusions	24
Apparent Violations of Laws and Regulations	24
Matters Requiring Attention	25
Directorate Responsibilities	25
Compliance with Enforcement Actions	26
Management/Risk Management	27
Analysis of Financial Factors	28
Information Technology Assessment	32
Bank Secrecy and Anti-Money-Laundering Compliance	32
Fiduciary Activities Assessment	32
Items Subject to Adverse Classification	33
Items Listed as Special Mention	34
Assets with Credit Data or Collateral Documentation Exceptions	35
Concentrations	36
Capital Calculations	37
Other Matters	38
Signature of Directors	39

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

---

**Scope**


---

**Summary of Examination Ratings<sup>1</sup>**

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
<b>Uniform Interagency Trust Rating System</b>			
Trust Composite Rating	_____	_____	_____
Management	_____	_____	_____
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<sup>2</sup>

---

*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.<sup>3</sup>

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.<sup>4</sup>

---

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<sup>5</sup>** - [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 <sup>6</sup>	_____	_____	_____	_____
Common Equity Tier 1 Capital Ratio <sup>7</sup>	_____	_____	_____	_____
Tier 1 Risk-Based Capital/Risk-Weighted Assets <sup>8</sup>	_____	_____	_____	_____
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 <sup>9</sup>	_____	_____	_____
Weighted Adversely Classified Assets <sup>10</sup> / 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 <sup>11</sup> (Subchapter S)	_____	_____	_____	_____
Net Interest Margin <sup>12</sup>	_____	_____	_____	_____
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 <sup>13</sup>	_____	_____	_____	_____
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	_____	_____	_____	_____
<b>Totals at Current Asset Review</b>	_____	_____	_____	_____
(Date)	_____	_____	_____	_____
<b>Totals at Prior Asset Review</b>	_____	_____	_____	_____
(Date)	_____	_____	_____	_____
<b>Totals at Prior Asset Review</b>	_____	_____	_____	_____
(Date)	_____	_____	_____	_____
<b>Totals at Prior Asset Review</b>	_____	_____	_____	_____
(Date)	_____	_____	_____	_____

**Specific Items Subject to Adverse Classification**

Amount, description, and comments	CATEGORY		
	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                     | 7 – Financial Statement                     |
| 2 – Title Search or Legal Opinion | 8 – Inadequate Income/Cash Flow Information |
| 3 – Borrowing Authorization       | 9 – Livestock Inspection                    |
| 4 – Recordation                   | 10 – Crop Inspection                        |
| 5 – Insurance                     | 11 – Other                                  |
| 6 – Collateral Assignment         |   |

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 concentration. 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<sup>14</sup>**


---

*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)
<b>Tier 1 Capital</b>		
Common Stock	_____	_____
Surplus	_____	_____
Undivided Profits and Capital Reserves	_____	_____
<i>Does not include appreciation (depreciation) on held-to-maturity and available-for-sale securities.</i>		
Noncumulative Perpetual Preferred Stock & Surplus	_____	_____
Minority Interests	_____	_____
Subtotal: Tier 1 Capital Elements	_____	_____
Less		
Other Adjustments	_____	_____
<b>Tier 1 Capital</b>		
<b>Tier 2 Capital</b>		
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	_____	_____
<b>Total Capital</b>		

---

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	_____	_____
<b>Adjusted Average Total Assets</b>	_____	_____
<b>Memoranda</b>	_____	_____
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.



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

# Consolidated Supervision Framework for Large Financial Institutions

Effective date April 2014

## Section 1005.1

The Federal Reserve adopted a new framework for the consolidated supervision of large financial institutions on December 17, 2012.<sup>1</sup> 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<sup>2</sup> 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<sup>3</sup> and banking offices<sup>4</sup> 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.<sup>5</sup> (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 identi-

fied 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.<sup>6</sup> 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.<sup>7</sup> 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.<sup>8</sup>
  - 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.
- 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.<sup>10</sup>
  - 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.<sup>11</sup>
  - 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.

## 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.<sup>9</sup> These areas should receive sufficient operational support to remain in a safe and sound condition under a broad range of stressed conditions.

## 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.

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.

- c) Ensure that recovery planning reflects a holistic view of sustainability and resiliency. 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.<sup>12</sup>
- 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, mea-

surement, 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

<sup>12</sup> 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.

ability to support its banking offices.<sup>13</sup> Each firm should:

- 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.<sup>14</sup>

## Resolution Planning

To promote financial stability, the Dodd-Frank Act requires each bank holding company with

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. 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.

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.<sup>15</sup>

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.

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.

## 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 stability 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<sup>16</sup> 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

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.

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 formal 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).<sup>17</sup> 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.<sup>18</sup>

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<sup>19</sup> in evaluating a firm under the Board's capital plan rule and the associated annual Comprehensive Capital Analysis and Review (CCAR).<sup>20</sup>

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 mini-

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](http://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.

minimum regulatory capital requirements to cover this difference.<sup>21</sup> 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 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.<sup>22</sup> 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,<sup>23</sup> 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)<sup>24</sup> should apply the seven guide-

---

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

---

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

22. See generally 12 CFR 217.1(d)(1), (d)(3), and (d)(5). In

lines, 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.<sup>25</sup>

- **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 institu-

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 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.

tions 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.

### 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.<sup>1</sup> 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.<sup>2</sup> 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).<sup>3</sup> 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.<sup>4</sup> 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

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*.

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

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.<sup>5</sup> 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”)<sup>6</sup> 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.<sup>7</sup>

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.<sup>8</sup> 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. Sec-

tion 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. Gov-

ernment 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.<sup>9</sup> 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

<i>Examination Type or Examined Entity</i>	<i>Relevant Guidance</i>
Holding Companies	<ul style="list-style-type: none"> <li>Federal Reserve's <i>Bank Holding Company Supervision Manual</i></li> <li><a href="#">SR-19-4/CA-19-3</a>, "Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than \$100 Billion"</li> <li><a href="#">SR-19-3/CA-19-2</a>, "Large Financial Institution Ratings"</li> <li><a href="#">SR-13-21</a>, "Inspection Frequency and Scope Requirements for Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of \$10 Billion or Less"</li> </ul>
Overseas Operations of U.S. Banking Organizations	<ul style="list-style-type: none"> <li>Sections 1050.1 and 1050.2 of the <i>Bank Holding Company Supervision Manual</i></li> <li><a href="#">SR-08-9</a>, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations"</li> </ul>

<i>Examination Type or Examined Entity</i>	<i>Relevant Guidance</i>
Edge Act and Agreement Corporations	<ul style="list-style-type: none"> <li>• SR-08-9, “Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations”</li> <li>• SR-90-21, “Rating System for International Examinations”</li> </ul>
U.S. Activities of Foreign Banking Organizations	<ul style="list-style-type: none"> <li>• SR-12-17/CA-12-14, “Consolidated Supervision Framework for Large Financial Institutions”</li> <li>• SR-08-9, “Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations”</li> <li>• SR-00-14, “Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations”</li> <li>• SR-96-36, “Guidance on Evaluating Activities Under the Responsibility of U.S. Branches, Agencies and Nonbank Subsidiaries of Foreign Banking Organizations (FBOs)”</li> </ul>
Information Technology Examinations	<ul style="list-style-type: none"> <li>• <i>FFIEC Information Technology Examination Handbook</i></li> <li>• The Information Technology section of this manual</li> <li>• SR-00-3, “Information Technology Examination Frequency”</li> <li>• SR-99-8, “Uniform Rating System for Information Technology”</li> </ul>
Trust Departments and Transfer Agent Activities	<ul style="list-style-type: none"> <li>• The Fiduciary Activities section of this manual</li> <li>• SR-01-5, “Examination of Fiduciary Activities”</li> <li>• SR-98-37, “Uniform Interagency Trust Rating System”</li> <li>• SR-96-10, “Risk-Focused Fiduciary Examinations”</li> </ul>
Municipal Securities Dealers Government Securities Dealers Clearing Agencies	<ul style="list-style-type: none"> <li>• SR-06-8, “Reports of Examinations of Government Securities Activities”</li> <li>• SR-94-5, “Government Securities Act Amendments of 1993”</li> <li>• SR-93-40, “Department of the Treasury Interpretation Regarding Allocation of Securities to Customer Accounts in Hold-in-Custody Repurchase Transactions”</li> <li>• SR-90-1, “Examination of State Branches and Agencies of Foreign Banks for Compliance with Regulations Related to Government Securities Activities”</li> <li>• SR-88-26, “Examination Procedures Relating To Government Securities Activities”</li> <li>• SR-87-37, “Examination Procedures Relating to Government Securities Activities”</li> <li>• SR-86-40, “Revised Municipal Securities Dealer Examination Procedures and Report Forms”</li> </ul>
Consumer Examinations	<ul style="list-style-type: none"> <li>• Federal Reserve’s <i>Consumer Compliance Handbook</i></li> </ul>

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<sup>1</sup> 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).<sup>2</sup> (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 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.<sup>3</sup> [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

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).

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.

“senior examiner” for a particular depository institution or depository institution holding company<sup>4</sup> 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),<sup>5</sup> central points of contact (CPCs), deputy CPCs, and supervisory team leaders.<sup>6</sup>

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.

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 restriction 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

<i>Examiner Responsibility</i>	<i>Restriction</i>
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	<ul style="list-style-type: none"> <li>• the state member bank (including any subsidiary of the state member bank) or</li> <li>• any company (including a bank holding company) that controls the state member bank.</li> </ul>
Bank holding company (BHC) or savings and loan holding company (SLHC)	<ul style="list-style-type: none"> <li>• the BHC or SLHC</li> <li>• any depository institution controlled by the BHC or SLHC (including any subsidiary of the depository institution).</li> </ul>
Foreign bank	<ul style="list-style-type: none"> <li>• the foreign bank,</li> <li>• any U.S. branch or agency of the foreign bank, or</li> <li>• any U.S. depository institution controlled by the foreign bank (including any subsidiary of the depository institution).</li> </ul>
Financial market utility (FMU)	<ul style="list-style-type: none"> <li>• the FMU, but only if it is a depository institution or depository institution holding company, or</li> <li>• any entity controlled by the FMU, but only if the FMU is a depository institution holding company (including any subsidiary of the entity).</li> </ul>
Nonbank financial company (NFC) that is designated by the Financial Stability Oversight Council (FSOC) for supervision by the Federal Reserve	<ul style="list-style-type: none"> <li>• the NFC if it is a depository institution or depository institution holding company, or</li> <li>• any entity controlled by the NFC, but only if the NFC is a depository institution holding company (including any subsidiary of the institution).</li> </ul>

# Federal Reserve System Bank Surveillance Program

Effective date April 2020

Section 1020.1

## 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 pre-

vious 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.<sup>1</sup>

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;<sup>2</sup> 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.

# Federal Reserve System Bank Surveillance Program

## Examination Objectives

Effective date April 2020

## Section 1020.2

---

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.

# Federal Reserve System Bank Surveillance Program

## Examination Procedures

Effective date April 2020

## Section 1020.3

---

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 over-

all 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 proce-

dures 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.

### INTRODUCTION

The board of directors plays an essential role in the management of a bank's operations and is directly responsible for the soundness of the bank. As a result, in some cases, it is useful for Federal Reserve examiners and/or officers to meet with boards of directors. These meetings provide examiners with the opportunity to inform directors of examination findings, discuss the bank's plans and prospects with the board, and highlight important supervisory issues, particularly in cases that may require initiation of informal or formal supervisory actions. Meetings with boards of directors also provide examiners with a limited opportunity to ascertain the directors' knowledge of and interest in the bank's operations.

If Federal Reserve examiners believe it is necessary or desirable, they may conduct meetings with directors immediately after the on-site portion of an examination and before an examination report is completed and distributed. Such meetings are particularly encouraged when they can be conducted as part of regularly scheduled board meetings that coincide with the on-site examination.

When a bank is determined to be a problem or has exhibited significant deterioration, Federal Reserve examiners must conduct meetings with the directors. Such meetings require the participation of Federal Reserve officers and are typically conducted after the report of examination has been distributed.

### GENERAL GUIDELINES

Meetings with boards of directors must be tailored to the individual circumstances of each bank, as well as to the Reserve Bank's supervisory objectives. As a result, uniform procedures for the conduct of these meetings cannot be specified. Nonetheless, the following guidelines should be considered when planning and conducting meetings with bank directors.

#### Content of Meetings

When participating in meetings with bank boards, examiners should present only informa-

tion needed by, or relevant to, the directorate. This information varies depending on the bank's circumstances; however, examiners should inform the board of the examiner's assessment of the bank's condition; highlight any deficiencies requiring the board's attention; and solicit the board's views on the bank's condition, operations, and prospects. In addition, examiners should obtain the board's commitment to address promptly the deficiencies identified in the examination. Examiners should encourage inquiries and discussions with the directors to learn more about the directors' roles and performance and to foster a good working relationship with them.

Data supporting the examiner's conclusions and comments should be prepared and presented to board members in a professional manner. Slides, handouts, and other visual aids are encouraged. Comparative figures and ratios from previous and present examinations should be reviewed prior to the meeting, with handouts and visual aids highlighting adverse trends.

#### Outlines for Meetings

Examiners should prepare detailed outlines of each meeting's discussion points and goals. Following is a sample outline that examiners may use as a guide to prepare for meetings with directors. It is not all-inclusive, and examiners should not be limited by its content in developing their own presentations. Generally, comments on these items are warranted when concerns have arisen during the current examination, or when significant changes—positive or negative—have occurred since the last examination.

- I. Introductory remarks by Federal Reserve Bank official or examiner
  - A. Federal Reserve Bank policy regarding board meeting
  - B. Purpose of the meeting
- II. Examiner's presentation
  - A. Duties and responsibilities of directors
    1. Effectively supervise the bank's affairs
    2. Select competent management
    3. Adopt and follow sound, written policies and objectives
    4. Avoid self-serving practices

5. Be informed of the bank's financial condition and management policies
  6. Maintain reasonable capitalization
  7. Observe banking laws and regulations
  - B. Adequacy and effectiveness of policies and procedures
    1. Lending
    2. Investments
    3. Asset/liability management
    4. Personnel
    5. Operations
  - C. Adequacy and accuracy of bank's reporting systems
    1. Reports of the board and committees
    2. Management reports to the board
    3. Management information systems
    4. Regulatory reports
  - D. Condition of the bank/results of the examination
    1. Asset quality
    2. Violations of law, evidence of self-dealing
    3. Capital
    4. Management
    5. Liquidity
    6. Earnings
    7. Internal controls and audit coverage
    8. Future prospects
    9. Relationships with bank holding company
  - E. Required corrective action on problems and board commitment
- III. Summary of overall conclusions
- IV. Questions from the board

## Procedural Issues

In general, meetings with the full board are preferable. In certain cases, however, a Reserve Bank may determine that meeting with a board committee, such as the executive or audit committee, will fulfill the Reserve Bank's supervisory objectives. Any person connected with the bank, such as an attorney, auditor, or holding company representative, may attend the board of directors meeting at which the overall findings and conclusions of the examination are discussed. The attendance of any such party should be noted in the minutes of the meeting. However, the examiner may excuse such persons during any portion of his or her presentation if deemed appropriate. Attendance by honorary directors to participate in discussions

and review the examination report is also permitted.

Generally, at least one member of a Reserve Bank's official staff is expected to represent the Federal Reserve at meetings with directors of banks. However, for meetings with the directors of banks that have less than \$500 million in assets, Reserve Banks are granted the discretion to have senior examination staff represent the Reserve Bank. The participation of Reserve Bank presidents in meetings with directors is left to the discretion of the Reserve Bank.

To the extent possible, meetings with the boards of directors of state member banks should include representatives of the relevant state banking authority. A meeting with the directors of a bank that is owned by a holding company may be held at the same time as a meeting with the directors of the holding company, when appropriate.

Whenever a meeting is held between an examiner and a board, the examiner should prepare written comments on the meeting for examination workpapers.

## MEETINGS WITH BOARDS OF PROBLEM BANKS AND BANKS EXHIBITING SIGNIFICANT DETERIORATION

When an examination reveals that a bank has significant problems, Federal Reserve policy requires that a meeting be held with its board of directors. The policy further requires that a written summary of examination findings—separate from the complete examination report—be distributed to each director in such cases. A senior Reserve Bank official also must participate in communicating and presenting examination findings on problem banks to their boards of directors. This policy's objective is to ensure that each director of a state member bank considered to be a problem or to have a significant weakness clearly understands the nature and dimension of the problems, as well as the joint and several responsibility of the directors to effect correction.

## Criteria Requiring Meetings with Problem Banks

A meeting with the board of directors is to be held after any full-scope examination in which

a state member bank is assigned a CAMELS composite rating of 4 or 5. A meeting is also required if a bank is rated composite 3 and its condition appears to be deteriorating or has shown little improvement since a previous examination in which it received a composite 3 rating. Furthermore, a meeting should be held after a targeted examination if deemed appropriate and desirable by the Reserve Bank. An official of the Reserve Bank and the examiner-in-charge should also meet with a board if any of the following conditions exist:

- The bank is entering into a formal written agreement with the Federal Reserve, a cease-and-desist order is being issued, or the bank is being placed under a memorandum of understanding.
- The bank is already operating under a supervisory action but is in noncompliance with significant provisions or has experienced significant deterioration since the action was initiated.
- Self-serving activities or other unsafe and unsound practices exist in the bank.
- Any other condition or practice that places, or could place, the bank in a seriously weakened or extended condition has been identified during the examination.

### Additional Guidelines

Senior Reserve Bank officials are expected to participate in meetings with the directors of problem banks, with the seniority of the participating official determined by the condition and size of the bank. The larger the organization or the more serious its problems, the more senior the Federal Reserve official should be.

A meeting with the board of directors of a problem or deteriorating bank should include a formal, structured presentation with a clear statement that the bank is considered a “problem institution” or is about to become a problem institution if existing conditions deteriorate. The presentation should further make clear the nature of problems confronting the bank, citing examination findings such as the following:

- deficiencies in capital, asset quality, earnings, or liquidity
- violations of law
- inadequacies in policies, practices, and report-

ing systems necessary for proper risk management and organizational administration

- lack of well-documented lending, collection, investment, asset/liability management, and risk-management policies or the failure to ensure that such policies are being followed
- failure of management to address previously discussed deficiencies
- lack of reporting systems sufficient to keep senior management and the board of directors fully informed
- failure of the board of directors to ensure the active management of the organization

### MEETINGS WITH BOARDS OF MULTINATIONAL AND MAJOR REGIONAL BANKS

A meeting with the board of directors is required after every full-scope examination of a multinational organization or major regional organization with assets in excess of \$5 billion. Reserve Banks also are encouraged to conduct such meetings after every full-scope examination of a regional bank with assets in excess of \$1 billion.

### MEETINGS WITH BOARDS OF DE NOVO BANKS

After the approval of a membership application, but before a de novo bank is opened, Reserve Bank staff should meet with the full board of directors to discuss applicable statutes, regulations, policies, and supervisory procedures. As with all meetings with directors, the agenda for this meeting should be tailored to the individual circumstances of the bank. At a minimum, the Reserve Bank should apprise the directors of their responsibilities and emphasize their need to adhere to sound operating policies.

### DIRECTOR’S SUMMARY OF EXAMINATION FINDINGS

In addition to the report of examination, Federal Reserve Banks must provide written reports to directors summarizing the examination findings for all banks rated composite 3, 4, or 5, and for those rated composite 1 or 2 that show signs of significant deterioration in condition or apparent

violations of law. The summary reports should focus on identified problems—rather than on the strength of the organization—and present the bank’s deficiencies succinctly and clearly. In all cases, the types of actions directors and management should take to address identified problems should be specifically stated. Directors of institutions rated 4 or 5 are to be told their banks are “problem” institutions that warrant “special supervisory attention.” Directors of banks rated 3 are to be informed that the bank’s condition is “not satisfactory,” that the bank is subject to “more-than-normal supervision,” and that the bank may become a “problem” if weaknesses are not addressed adequately.

Summary reports should emphasize the responsibilities of the directors to ensure that corrective actions are taken to address all deficiencies noted in the pages of the full bank examination report entitled “Matters Requiring Board Attention” and “Examination Conclusions and Comments.” In addition, the organization, style, and content of the summary report should be similar, if not identical, to the text of these report pages.

Summary reports should be sent directly to the bank’s management for distribution to each director. The transmittal letter to the bank should state the report is a summary of identified problems and contemplated supervisory actions and direct bank management to distribute the summary report to each director. The letter should further instruct each director to read the report, sign the introductory statement attesting to having read the report, and return the report to management. Management should keep copies of the directors’ signed statements on file, but should destroy all but one file copy of the summary report itself.

The summary report must be completed and distributed before any meeting between Reserve Bank officials and the bank’s board of directors, to provide the directors with prior notice of deficiencies to be discussed. Reserve Banks should also make every effort to distribute the complete examination report to management before meeting with a board of directors.

# Meetings with Board of Directors

## Examination Objectives

Effective date March 1984

## Section 1040.2

---

1. To foster a better understanding of the respective roles of directors and examiners.
2. To inform the directors of the examination scope and the bank's condition.
3. To obtain information concerning future plans and proposed changes in bank policies that may have significant impact on the future condition of the bank.
4. To reach an agreement on any significant problems.
5. To obtain a commitment to initiate appropriate corrective action.

# Meetings with Board of Directors

## Examination Procedures

Effective date March 1984

## Section 1040.3

1. Inform management that a meeting will be held with the board of directors. State the Federal Reserve Bank's policy and the purpose of the meeting and establish a tentative date.
2. Finalize the time and place of the meeting when confident that a thorough understanding of the condition of the bank will be developed. If the meeting is to be a "special meeting" resulting from serious areas of concern, perform procedure 7.
3. Develop an outline of matters to be covered at the meeting by reviewing results of the examination.
4. Prepare supportive data for the meeting by:
  - a. Compiling a list of comments and criticisms.
  - b. Preparing schedules of comparative figures for discussion.
  - c. Affirming that the bank has responded adequately to Reserve Bank requests.
  - d. Preparing questions to elicit opinions and attitudes of individual board members.
5. Prepare a brief formal agenda for the meeting and reproduce enough copies to distribute to participants.
6. If it is decided that a meeting will be held:
  - a. Communicate with Reserve Bank office to:
    - Notify office staff of the proposed date and place of the meeting. (Confirm time and place when final.)
    - Determine whether a Reserve Bank official will attend.
    - Determine whether the Reserve Bank official has suggestions for the agenda.
  - b. Submit a copy of the agenda and outline in advance to the Reserve Bank official.
  - c. Inform directors that the following must be submitted to the Reserve Bank office:
    - A copy of a board resolution stating corrective action.
    - A written plan for corrective action to be forwarded within a specified time period.
    - Periodic progress reports.
7. For "special meetings" resulting from serious problems:
  - a. Communicate with the Reserve Bank to:
    - Notify office staff of the proposed date and place of the meeting.
    - Determine whether a Reserve Bank official will attend.
    - Determine whether the Reserve Bank official has suggestions for the agenda.
  - b. Confirm the final time and place of the meeting with the Reserve Bank office.
  - c. Prepare any special supporting data for the meeting, such as areas of noncompliance with memorandums of understanding or cease and desist agreements or orders.
8. Conduct the board meeting in accordance with the agenda and previously prepared outline, being certain to discuss:
  - a. Major criticisms noted during the examination.
  - b. Conclusions reached about the bank in general.
  - c. Expected future conditions.
  - d. Potential problems.
  - e. Planned corrective action:
    - Examiner's recommendations.
    - Management's commitments.
    - Director's commitments.
9. Obtain a definite agreement or commitment from the board that appropriate corrective action will be taken.
10. Prepare a memorandum covering the meeting with the board to include, as a minimum:
  - a. The time and place of the meeting.
  - b. The directors and guests in attendance.
  - c. The matters subject to criticism that were reviewed.
  - d. A summary of the general discussion on the matters presented to the board.
  - e. A summary of the director's reaction to the situation and any commitments obtained from them.
11. Request that copies of the minutes of the board meeting be forwarded to the Reserve Bank and the examiner-in-charge.

The Federal Reserve Board has a broad range of enforcement powers over both domestic and foreign financial institutions and over the individuals associated with them. Generally, formal or informal enforcement actions are taken after the completion of an onsite 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.

In addition to the Board's jurisdiction over financial institutions, the Board also has jurisdiction over individuals associated with financial institutions. The term "institution-affiliated party" includes any officer, director, employee, controlling shareholder, or agent of a financial institution, and any other person who has filed or is required to file a change-in-control notice. It also includes any shareholder, consultant, joint-venture partner, or any other person who participates in the conduct of the affairs of the financial institution as well as any independent contractors, including attorneys, appraisers, and accountants, who knowingly or recklessly participate in any violation of law or regulation, breach of fiduciary duty, or unsafe or unsound practice that causes (or is likely to cause) more than a minimal financial loss to, or a significant adverse effect on, a financial institution.<sup>1</sup> The Board's jurisdiction over an institution-affiliated party extends for up to six years after the party's resignation, termination of employment, or separation caused by the closing of a financial institution, provided that any notice (such as a notice of intent to remove from office and of prohibition) is served on the party before the end of a six-year period.

## FORMAL SUPERVISORY ACTIONS

The following statutory tools are available to the Board in the event formal supervisory action is

warranted against a state member bank or any institution-affiliated party. The objective of formal action is to correct practices that the regulators believe to be unlawful, unsafe, or unsound.<sup>2</sup> The initial consideration and determination of whether formal action is required usually results from examination findings. It is important to provide adequate support for all recommendations for both formal and informal actions in the examination report and associated workpapers.

## Types of Supervisory Actions

Generally, under section 8 of the Federal Deposit Insurance Act (FDI Act) (12 USC 1818(b)), the Board may use its cease-and-desist authority and civil money penalty authority against any state member bank and any institution-affiliated party that meets the statutory criteria for issuing such an order. Prohibition and removal actions may be taken against any institution-affiliated party who meets the statutory criteria to bring such an action.

### *Cease-and-Desist Orders*

Generally, under 12 USC 1818(b), the Board may use its cease-and-desist authority against a state member bank and any institution-affiliated party when it finds that a bank or party is engaging, has engaged, or is about to engage in (1) a violation of law, rule, or regulation; (2) a violation of a condition imposed in writing by the Board in connection with the granting of any application or any written agreement; or (3) an unsafe or unsound practice in conducting the business of the institution. Separately, under 12 USC 1818(s), the Board must initiate a cease-and-desist action against a bank when it has failed to establish and maintain the Bank Secrecy Act procedures required by the Board's Regulation H or has failed to correct any previously noted deficiencies related to these procedures.

A cease-and-desist order may require the bank or person subject to the order to (1) cease

1. The Board is authorized to issue regulations further defining which individuals should be considered institution-affiliated parties. Similarly, the Board may determine whether an individual is an institution-affiliated party on a case-by-case basis. (See 12 USC 1813(u).)

2. An unsafe or unsound practice is defined as any action that is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance fund.

and desist from the practices or violations or (2) take affirmative action to correct the violations or practices. Affirmative actions include actions necessary to restore the bank to a safe and sound condition, such as measures to improve asset quality. The order may also include restrictions on growth, debt, and dividends; require the disposition of any loan or asset; require the employment of qualified officers or employees; require restitution, reimbursement, indemnification, or guarantee against loss if the bank or person was unjustly enriched by the violation or practice or if the violation or practice involved a reckless disregard for the law or applicable regulations or a prior order; and any other action the Board determines to be appropriate.

Most cease-and-desist orders are issued by consent. When Board staff, in conjunction with the appropriate Reserve Bank, determines that a cease-and-desist action is necessary, the bank or person is generally given an opportunity to consent to the issuance of the order without the need for the issuance of a notice of charges and a contested administrative hearing. Board staff drafts the proposed cease-and-desist order and, with Reserve Bank staff, presents it to the bank or individual for consent. Banks or individuals are advised that they may have legal counsel present at all meetings with Board or Reserve Bank staff concerning formal supervisory actions. If the parties voluntarily agree to settle the case by the issuance of a consent cease-and-desist order, the proposed consent order will be presented to senior Board officials for approval, at which time the order will be final and binding.

When a bank or person fails to consent to a cease-and-desist order, the Board may issue a notice of charges and of hearing to the bank or party. The notice of charges contains a detailed statement describing the facts constituting the alleged violations or unsafe or unsound practices. The issuance of the notice of charges and of hearing starts a formal process that includes the convening of a public administrative hearing<sup>3</sup> conducted before an administrative law judge, appointed by the Board. After the hearing, the judge makes a recommended decision to the Board. A hearing must be held within 30 to 60 days of service of the notice of charges, unless a later date is set by the administrative

law judge. After the Board considers the record of the proceeding, including the administrative law judge's recommended decision, it determines whether to issue a final cease-and-desist order. Banks and individuals who are subject to cease-and-desist orders that were issued as a result of contested proceedings may appeal the order to the appropriate federal court of appeals.

### *Temporary Cease-and-Desist Orders*

If a violation or threatened violation of law, rule, or regulation, or if engaging in an unsafe or unsound practice that is specified in the notice of charges, is likely to cause the bank's insolvency, cause significant dissipation of the bank's assets or earnings, weaken the bank's condition, or otherwise prejudice the interests of depositors before the completion of the proceedings (initiated by the issuance of the notice of charges), the Board may, in conjunction with issuing a notice of charges, issue a temporary cease-and-desist order against the bank to effect immediate correction (pursuant to 12 USC 1818(c)).

The Board may also issue a temporary order if it determines that the bank's books and records are so incomplete or inaccurate that the Board is unable to determine, through the normal supervisory process, the bank's financial condition or the details or purpose of any transaction that may have a material effect on the bank's condition. The temporary order may require the bank to take the same corrective actions as a cease-and-desist order. The advantage of issuing a temporary cease-and-desist order is that it becomes effective immediately after it is served on the bank or individual. Within 10 days after being served with a temporary order, however, the entity or individual may appeal to a U.S. district court for relief from the order. Unless set aside by the district court, the temporary order stays in effect until the Board issues a final cease-and-desist order or dismisses the action.

### *Written Agreements*

When circumstances warrant a less severe form of formal supervisory action, a written agreement may be used. A written agreement is generally with the Reserve Bank under delegated authority (12 CFR 265.11(a)(15)). Written agreements are drafted by Board staff, in

3. A private hearing may be held if the Board determines that holding a public hearing would be contrary to the public interest.

consultation with Reserve Bank staff, and must be approved by the Board's Director of the Division of Banking Supervision and Regulation and the General Counsel before issuance. The provisions of a written agreement may relate to any of the problems found at the bank or to any problems involving institution-affiliated parties.

### *Prompt-Corrective-Action Directives*

Please see section 4133.1 for a discussion of prompt-corrective-action directives, which are a type of formal supervisory action issued when a bank's capital ratios fall below certain specified levels.

### Prohibition and Removal Authority

The Board is authorized by 12 USC 1818(e) to remove any current institution-affiliated party of a bank for certain violations and misconduct and to prohibit permanently from the banking industry any current or former institution-affiliated party from future involvement with any insured depository institution, bank or thrift holding company, and nonbank subsidiary.<sup>4</sup>

The Board is authorized to initiate removal or prohibition actions when

- the institution-affiliated party has directly or indirectly—
  - violated any law, regulation, cease-and-desist order, condition imposed in writing, or written agreement;
  - engaged in any unsafe or unsound practice; or
  - breached a fiduciary duty;
- the Board determines that, because of the violation, unsafe or unsound practice, or breach—
  - the institution has suffered or will probably suffer financial loss or other damage;
  - the interests of depositors have been or could be prejudiced by the violation, practice, or breach; or
  - the institution-affiliated party has received financial gain or other benefit from the violation, practice, or breach; and

- the violation, practice, or breach—
  - involves personal dishonesty or
  - demonstrates a willful or continuing disregard for the safety or soundness of the institution.

The statute also authorizes the Board to initiate removal or prohibition actions against (1) any institution-affiliated party who has committed a violation of any provision of the Bank Secrecy Act that was not inadvertent or unintentional, (2) any officer or director of a bank who has knowledge that an institution-affiliated party has violated the money-laundering statutes and did not take appropriate action to stop or prevent the reoccurrence of such a violation, or (3) any officer or director of a bank who violates the prohibitions on management interlocks. These removal or prohibition actions for these violations do not require a finding of gain to the individual, loss to the institution, personal dishonesty, or willful or continuing disregard for the safety or soundness of the institution.<sup>5</sup>

If an institution-affiliated party's actions warrant immediate removal from a state member bank, the Board is authorized to suspend the person temporarily from that bank pending the outcome of the complete administrative process. An institution-affiliated party presently associated with a bank may also be suspended or removed for cause based on actions taken while formerly associated with a different insured depository institution, bank holding company, or "business institution." Business institution is not specifically defined in the statute so that it may be interpreted to include any other business interests of the institution-affiliated party.

Under 12 USC 1818(g), the Board is authorized to suspend from office or prohibit from further participation any institution-affiliated party charged or indicted for the commission of a crime involving personal dishonesty or breach of trust that is punishable by imprisonment for a term exceeding one year under state or federal law, if the continued participation might threaten either the interests of depositors or public confidence in the bank. The Board may also suspend or prohibit any individual charged with a violation of the money-laundering statutes. The suspension can remain in effect until the criminal action is disposed of or until the suspension is terminated by the Board. The Board may also initiate a removal or prohibition action against

4. This authority is distinct from the Board's authority under prompt corrective action to dismiss senior officers from a particular bank.

5. See 12 USC 1818(e)(2).

an institution-affiliated party who has been convicted of, or pleaded to, a crime involving personal dishonesty or breach of trust if his or her continued service would threaten the interests of the depositor or impair public confidence in the institution. The Board is required to issue such an order against any institution-affiliated party who has been convicted of, or pleaded to, a violation of the money-laundering statutes.

Furthermore, 12 USC 1829 prohibits any individual who has been convicted of a crime involving dishonesty, breach of trust, or money laundering from (1) serving as an institution-affiliated party of, (2) directly or indirectly participating in the affairs of, and (3) owning or controlling, directly or indirectly, an insured depository institution without the Federal Deposit Insurance Corporation's (FDIC's) prior approval. The statute also prohibits a convicted person from holding a position at a bank holding company or nonbank affiliate of a bank without the prior approval of the Board of Governors of the Federal Reserve System. The penalty for violation of this law is a potential fine for a knowing violation of up to \$1 million per day, imprisonment for up to five years, or both. The criminal penalty applies to both the individual and the employing institution.

## Violations of Final Orders and Written Agreements

When any final order or temporary cease-and-desist order has been violated, the Board may apply to a U.S. district court for enforcement of the action. The court may order and require compliance.

Violations of final orders and written agreements may also give rise to the assessment of civil money penalties against the offending bank or institution-affiliated party, as circumstances warrant. The civil money penalty is assessed in the same manner as described in the "Civil Money Penalties" subsection below. Any institution-affiliated party who violates a suspension or removal order is subject to a criminal fine of up to \$1 million, imprisonment for up to five years, or both.

## Civil Money Penalties

The Board may assess civil money penalties of up to \$7,500 per day against any institution or institution-affiliated party for any violation of (1) law or regulation; (2) a final cease-and-desist, temporary cease-and-desist, suspension, removal, or prohibition order or for failure to comply with a prompt-corrective-action directive; (3) a condition imposed in writing by the Board in connection with the granting of an application or other request; and (4) a written agreement.

A fine of up to \$37,500 per day can be assessed for a violation, an unsafe or unsound practice recklessly engaged in, or a breach of fiduciary duty when the violation, practice, or breach is part of a pattern of misconduct, causes or is likely to cause more than a minimal loss to the bank, or results in pecuniary gain or other benefit for the offender. A civil money penalty of up to \$1.375 million per day can be assessed for any knowing violation, unsafe or unsound practice, or breach of any fiduciary duty when the offender knowingly or recklessly caused a substantial loss to the financial institution or received a substantial pecuniary gain or other benefit. Civil money penalties may also be assessed, under the three-tier penalty framework described above, for any violation of the Change in Bank Control Act and for violations of the anti-tying provisions of federal banking law, among other provisions.<sup>6</sup>

The Board may also assess civil money penalties for the submission of any late, false, or misleading call reports. If a financial institution maintains procedures that are reasonably adapted to avoid inadvertent errors, but unintentionally fails to publish any report, submits any false or misleading report or information, or is minimally late with the report, it can be assessed a fine of up to \$2,200 per day. The financial institution has the burden of proving that the error was inadvertent under these circumstances. If the error was not inadvertent or the bank lacked the appropriate procedures, a penalty of up to \$32,000 per day can be assessed for all false or misleading reports or information submitted to the Board. If the submission was done in a knowing manner or with reckless disregard for the law, a fine of up to \$1.375 million or 1 percent of the institution's assets, whichever is less, can be assessed for each day

6. See 12 USC 1972.

of the violation. Under its general civil money penalty authority, the Board may also assess civil money penalties against any institution-affiliated party who participates in a bank's filing of late, false, or misleading call reports.

## Administration of Formal Actions

### *Publication of Final Orders*

Under 12 USC 1818(u), 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. The Board is also required to publish and make publicly available any written agreement or other written statement that it may enforce, unless the Board determines that publication of the order or agreement would be contrary to the public interest.

### *Public Hearings*

Under 12 USC 1818(u), all formal hearings, including contested cease-and-desist, removal, and civil money penalty proceedings, are open to the public unless the Board determines that a public hearing would be contrary to the public interest. Transcripts of all testimony; copies of all documents submitted as evidence in the hearing, which could include examination or inspection reports and supporting documents (except those filed under seal); and all other documents, such as the notice and the administrative law judge's recommended decision, are available to the public. These documents could include examiners' workpapers, file memorandums, reports of examination and inspection, and correspondence between a problem institution or wrongdoer and the Federal Reserve Bank. Appropriate actions should always be taken to ensure that all written material prepared in connection with any supervisory matter be accurate and free of insupportable conclusions or opinions.

### *Appointment of Directors and Senior Executive Officers*

Under section 32 of the FDI Act (12 USC 1831i) and subpart H of Regulation Y (12 CFR 225.71 et seq.), any state member bank or bank holding

company that is in a troubled condition<sup>7</sup> or does not meet minimum capital standards must provide 30 days' written notice to the Board of Governors before appointing any new director or senior executive officer.<sup>8</sup> This requirement also applies to any change in the responsibilities of any current senior executive officer who is proposing to assume a different senior officer position. Subpart H of Regulation Y details the procedures for filing and the content of the notice. The Board may disapprove a notice if it finds that the competence, experience, character, or integrity of the proposed individual indicates that his or her service would not be in the best interest of the institution's depositors or the public. A disapproved individual or the institution that filed the notice may appeal the Federal Reserve's notice of disapproval under the procedures detailed in Regulation Y. The individual may not serve as a director or senior executive officer while the appeal is pending. In the event that a state member bank or bank holding company that is in a troubled condition appoints a director or senior officer without the required 30 days' prior written notice, appropriate follow-up supervisory action should be taken.

## INFORMAL SUPERVISORY ACTIONS

Informal supervisory tools 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 memoranda of understanding.

7. As defined in section 225.71 of the Board's Regulation Y, a state member bank or holding company is in troubled condition if it (1) has a composite rating, determined at its most recent examination, of 4 or 5; (2) is subject to a cease-and-desist order or formal written agreement that requires action to improve the bank's financial condition; or (3) is expressly informed by the Board or Reserve Bank that it is in troubled condition.

8. The Board or Reserve Bank may permit, under extraordinary circumstances, an individual to serve as a director or senior executive officer before a notice is provided; however, this permission does not affect the Federal Reserve's authority to disapprove a notice within 30 days of its filing. The Board may extend the review period to a maximum of 90 days if needed to process the notice.

- *Commitments* are generally used to correct minor problems or to request periodic reports addressing certain aspects of a bank's operations. Commitments may be used when there are no significant violations of law or unsafe or unsound practices and when the bank and its officers and directors are expected to cooperate and comply.<sup>9</sup> Commitments are generally obtained by the Reserve Bank's sending a letter to the bank outlining the request and asking for a response and an indication that the commitments are accepted.
- *Board resolutions* generally represent a number of commitments made by the bank's directors and are incorporated into the bank's corporate minutes. The Reserve Bank may request board resolutions in the examination transmittal letter, which asks the bank to provide it with a signed copy of the corporate resolution.
- *Memoranda of understanding (MOU)* are highly structured written, but informal, agreements that are signed by both the Reserve Bank and the bank's board of directors. An MOU is generally used when a bank has multiple deficiencies that the Reserve Bank believes can be corrected by the present management.

## INDEMNIFICATION PAYMENTS AND GOLDEN PARACHUTE PAYMENTS

In general, an indemnification payment is a payment that reimburses an insider for a specified liability or cost that the person incurred in connection with a Federal Reserve investigation or enforcement action. Golden parachute payments are severance payments or agreements to make severance payments that are paid or entered into at a time when the bank or holding company is in a troubled condition. These payments require the prior written approval of the institution's primary federal regulator and the concurrence of the FDIC. Although both types of payments fall under the same statute—section 18(k) of the FDI Act (12 USC 1828(k)) and the FDIC's accompanying regulations<sup>10</sup>—the two

types of payments are quite different and distinct. However, some of the restrictions on these payments are the same or similar.

### Indemnification Agreements and Payments

State member banks may seek to indemnify their officers, directors, and employees from any judgments, fines, claims, or settlements, whether civil, criminal, or administrative. The bylaws of some state member banks may have broadly worded indemnification provisions, or the bank may have entered into separate indemnification agreements that cover the ongoing activities of its own institution-affiliated parties. Such indemnification provisions may be inconsistent with federal banking law and regulations, as well as with safe and sound banking practices.

Supervisory and examiner staff should be alert to the limitations and prohibitions on indemnification imposed by section 18(k) of the FDI Act and the regulations issued thereunder by the FDIC. The law and regulations apply to indemnification agreements and payments made by any bank to any institution-affiliated party, regardless of the condition of the financial institution. The purpose of the law and regulations is to preserve the deterrent effects of administrative enforcement actions (by ensuring that individuals subject to final enforcement actions bear the costs of any judgments, fines, and associated legal expenses) and to safeguard the assets of financial institutions.

A prohibited indemnification payment includes any payment (or agreement to make a payment) by a state member bank to an institution-affiliated party to pay or reimburse such person for any liability or legal expense incurred in any Board administrative proceeding that results in a final order or settlement in which the institution-affiliated party is assessed a civil money penalty, is removed or prohibited from banking, or is required to cease an action or take any affirmative action, including making restitution, with respect to the bank.

The FDIC's regulations provide criteria for making permissible indemnification payments. A bank may make or agree to make a reasonable indemnification payment if all of the following conditions are met: (1) the institution's board of directors determines in writing that the institution-affiliated party acted in good faith and the best

9. Informal commitments are distinct from conditions imposed in writing in connection with the grant of an application or other request by an institution, which may be enforced through the imposition of a civil money penalty.

10. See 12 CFR 359.

interests of the institution; (2) the board of directors determines that the payment will not materially affect the institution's safety and soundness; (3) the payment does not fall within the definition of a prohibited indemnification payment; and (4) the institution-affiliated party agrees in writing to reimburse the institution, to the extent not covered by permissible insurance, for payments made in the event that the institution-affiliated party does not prevail.

The law and the FDIC's regulations apply to all state member banks. They reinforce the Federal Reserve's longstanding policy that an institution-affiliated party who engages in misconduct should not be insulated from the consequences of his or her misconduct. From a safety and soundness perspective, a state member bank should not divert its assets to pay a fine or other final judgment issued against an institution-affiliated party for misconduct that presumably violates the bank's policy of compliance with applicable law, especially in cases where the individual's misconduct has already harmed the bank.

State member banks should review their by-laws and any outstanding indemnification agreements, as well as insurance policies, to ensure that they conform with the requirements of federal law and regulations. If a state member bank fails to take appropriate action to bring its indemnification provisions into compliance with federal laws and regulations, appropriate follow-up supervisory action may be taken. As part of the supervisory process, which will include merger and acquisition applications, the Federal Reserve's supervisory and examiner staff will review identified agreements having indemnification-related issues for compliance with federal law and regulations. (See SR-02-17.)

## Golden Parachute Payments

The FDIC's golden parachute regulations apply to an insured depository institution that is in a troubled condition as defined in Regulation Y. The purposes of the law and regulations are to safeguard the assets of financial institutions and limit rewards to institution-affiliated parties who contributed to the institution's troubled condition.

In general, the FDIC's regulations (12 CFR 359) prohibit insured depository institutions and their holding companies from making golden parachute payments except in certain

circumstances. A golden parachute payment means any payment in the nature of compensation (or an agreement to make such a payment) for the benefit of any current or former institution-affiliated party of an insured depository institution or its holding company that meets three criteria. First, the payment or agreement must be contingent on the termination of the institution-affiliated party's employment or association. Second, the payment or agreement is received on or after, or made in contemplation of, among other things, a determination that the institution or holding company is in a troubled condition under the regulations of the applicable banking agency. Third, the payment or agreement must be payable to an institution-affiliated party who is terminated when the institution or holding company meets certain specific conditions, including being subject to a determination that it is in a troubled condition.

The definition of a golden parachute payment also covers a payment made by a bank holding company that is not in a troubled condition to an institution-affiliated party of an insured depository institution subsidiary that is in a troubled condition, if the other criteria in the definition are met. This circumstance may arise when a bank holding company, as part of an agreement to acquire a troubled bank or savings association, proposes to make payments to the troubled institution's institution-affiliated parties that are conditioned on their termination of employment.<sup>11</sup>

A state member bank or bank holding company may make or enter into an agreement to make a golden parachute payment only (1) if the Federal Reserve, with the written concurrence of the FDIC, determines that the payment or agreement is permissible; (2) as part of an agreement to hire competent management in certain conditions, with the consent of the Federal Reserve and the FDIC as to the amount and terms of the proposed payment; or (3) pursuant to an agreement to provide a reasonable severance not to exceed 12 months' salary in the event of an unassisted change in control of the depository

11. The FDIC's regulations exclude from the definition of a golden parachute payment several types of payments, such as payments made pursuant to a qualified pension or retirement plan; a benefit plan or bona fide deferred compensation plan (which are further defined in the FDIC's regulations); or a severance plan that provides benefits to all eligible employees, does not exceed the base compensation paid over the preceding 12 months, and otherwise meets the regulatory definition of nondiscriminatory and other conditions in the FDIC's regulations.

institution, with the consent of the Federal Reserve. In determining the permissibility of the payment, the Federal Reserve may consider a variety of factors, including the individual's degree of managerial responsibilities and length of service, the reasonableness of the payment, and any other factors or circumstances that would indicate that the proposed payment would be contrary to the purposes of the statute or regulations.

A state member bank or bank holding company requesting approval to make a golden parachute payment or enter into an agreement to make such a payment should submit its request simultaneously to the appropriate FDIC regional office and the Reserve Bank. The request must detail the proposed payments and demonstrate that the state member bank or bank holding company does not possess and is not aware of any evidence that there is reasonable basis to believe, at the time that the payment is proposed to be made, that (1) the institution-affiliated party receiving such a payment has committed any fraud, breach of fiduciary duty, or insider abuse or has materially violated any applicable banking law or regulation that had or is likely to have a material adverse effect on the bank or company; (2) that the individual is substantially responsible for the institution's insolvency or troubled condition; (3) and that the individual has violated specified banking or criminal laws.

Requests regarding golden parachute payments or agreements should be forwarded by the Reserve Bank to the appropriate Board staff for a final determination on the permissibility of the payment. Golden parachute payments or agreements must be approved by the Board's Director of the Division of Banking Supervision and Regulation and the General Counsel. Denials are not delegated by the Board of Governors to Board or Reserve Bank staffs.

If a state member bank or bank holding company makes or enters into an agreement to make a golden parachute payment without prior regulatory approval when such an approval is required, appropriate follow-up supervisory action should be taken. This follow-up could include an enforcement action requiring the offending institution-affiliated party to reimburse the institution for the amount of the prohibited payment. When state member banks or bank holding companies are identified as having golden parachute-related issues in the supervisory process, those issues should be carefully reviewed for compliance with the law and the FDIC's regulations. The appropriate Reserve Bank supervisory staff and the appropriate staff of the Board's Division of Banking Supervision and Regulation and Legal Division should be notified and consulted on the golden parachute-related issues.

# Overall Conclusions Regarding Condition of the Bank

## Section 1100.1

Effective date April 2020

The examiner is encouraged to use objective criteria in evaluating various areas of the bank. However, there will always be a need for subjective judgment in an examination. Formulating an overall conclusion regarding the present and future condition of the bank requires the use of both objective criteria and subjective judgment. As experience is essential in evaluating information in areas requiring subjective judgment, the procedures in this section should be performed by the Central Point of Contact (CPC) or the examiner-in-charge (EIC) (EIC is meant to include the CPC). When performing these procedures, the examiner's primary concerns are—

- to make the ultimate determination as to—
  - the solvency of the bank and its ability to meet maturing and unusual demands in the ordinary course of business,
  - adherence to safe and sound banking practice,
  - adherence to the law, and
  - the continued viability of the institution, and
- to communicate the results of the examination to the Federal Reserve System and the directors of the bank.

The evaluation of the overall condition of the bank is based on conditions found throughout the institution. Considerations include internal control and policy exceptions, violations of law and regulations, quality of management, adequacy of earnings and capital, quantities of classified assets, and other identified deficiencies or irregularities. An evaluation of the future condition of the bank is based on the analysis of—

- management's plans as expressed by operating plans, the capital plan, and other projections,
- factors such as competition and economic conditions, and
- the overall present condition of the bank.

The primary information for evaluating the present condition of a bank is the findings and conclusions of the examination staff. The EIC should weigh the importance and significance of all criticisms, exceptions, and deficiencies in attempting to discover any unfavorable trends or situations. Through review of the examination

process, insight can be gained into such central issues as—

- present asset quality;
- current liquidity position;
- present capital adequacy position;
- quality and performance of management, including the management of the bank's risk;
- earnings performance, both past and present; and
- sources and applications of funds.

The EIC usually will include remarks regarding those areas in the examination report. Although procedural areas of this manual deal specifically with each of those key items, the EIC should use information from all phases of the examination. For example, when reviewing the bank's present capital position, the EIC may use knowledge of the bank's asset and management quality to modify the conclusions of assisting personnel. The important point is that the EIC is in the best position to assess all information provided by the examination process.

Factors affecting the future condition of the bank can generally be categorized as internal or external. The examiner's review of the current condition flows naturally into an evaluation of internal factors affecting the institution's future prospects and condition. Among the items providing insight into future conditions are—

- earnings trends,
- successor-management plans,
- the budget or profit plan,
- the capital plan, and
- any other internally generated projections or forecasts.

Many banks will not have formal written plans or projections. In such cases, the EIC must obtain from senior management or the board of directors information on their plans for matters such as—

- growth and expansion,
- capital,
- changes in the size and mix of assets and liabilities, and
- changes in sources of funding.

In addition, examiners should remind senior management that any change in the general character of a bank's business or the scope of

the corporate powers it exercises requires the prior approval of the Board under Regulation H.

The examiner should recommend that banks that do not have formal plans or projections take advantage of any externally available tools to aid them in formulating these plans. In today's competitive market, strategic planning is a necessity for almost all banks, but especially for banks that are losing their market share or in which inefficiencies are depressing profitability.

If banks prepare budgets or profit plans, insight can be gained into the accuracy of balance-sheet and earnings projections by comparing actual and projected account balances. It also is beneficial to compare original projections with current projections to determine that adjustments are made on a timely basis. When four- or five-year projections are made, banks often formulate several forecasts based on different sets of assumptions. In such a situation, the examiner should attempt to determine the bank's most likely future course.

The examiner should attempt to gain access to any official material or internal workpapers that document or illustrate the bank's rationale in planning its future. The goal is to review the institution's decision-making process.

Banks are increasingly engaging in off-balance-sheet activities to deliver services, effect payments, generate income, and to hedge interest-rate risks. Banks have introduced a wide variety of new products and services to complement their more traditional activities. Although these new activities are useful and profitable, they contain elements of risk. Many of these new activities involve a contingent liability or other risk that is not reflected on the bank's balance sheet and, indeed, may not even be fully recognized by the bank. The examiner should be aware of how the bank manages and controls its risks. Examples of off-balance-sheet activities include—

- guarantee contracts, retained or contingent interests, and variable interests,
- commitments and innovative applications for standby letters of credit, and
- a wide variety of financial instruments and investment-security activities (including futures and forwards, warrants, puts, and calls).

Risk can be distinguished primarily as credit risk, liquidity, market (price, interest rate, foreign exchange), operational, reputational, and legal risk. Risk can also result from internal

control deficiencies. Examiners must also be aware of the nature and extent of off-balance-sheet risks. The risks that affect capital, liquidity, and compliance with laws should be evaluated for their potential effect on the safety and soundness of the bank.

In judging such controversial areas as capital adequacy and liquidity, the examiner should remember that, under ideal circumstances, management should be the expert on the bank's capitalization and liquidity position. Judgments on such matters should be generated internally, based on insight only management can possess. It is management that should know the bank's competitive situation, the economics of the service area, and the anticipated impact of those and other factors on its plans for growth and expansion. It is also management that has the greatest interest in the success of the bank. Accordingly, management and the directorate should choose a level of capitalization and liquidity consistent with their perception of the bank's situation rather than reacting to competitors or relying on pressures from regulators. However, specific judgments by the examiner are required, particularly in situations where a capital or liquidity position has fallen below what examiners consider to be acceptable norms. Objective justification for lower levels of capital or liquidity must be obtained and analyzed.

To properly evaluate the future prospects of a bank, the examiner must review external factors affecting the institution. Significant among those factors are the characteristics of a bank's primary service area. The bank's primary service area is defined as that area from which the bank receives approximately 75 percent of its deposits. Demographics of the area generally are available, and every bank should accumulate such information to aid in analyzing its current operations and planning for future operations. The absence of such information in an up-to-date form should be considered a deficiency. Included under examination procedures for this section is a listing of minimum information required to ascertain the demographics of a service area. The EIC should make sure that information is compiled and should analyze it to determine whether management expectations appear justifiable in the circumstances.

In dealing with competitive factors, the examiner should review or compute the share of market for the bank under examination. Continuing records in that area establish an analyzable trend. Consideration also should be given

to changes in the bank's statutory and regulatory environment, such as—

- changes in branching laws,
- changes in tax structure, and
- changes in laws affecting competition with other financial institutions.

Once the examiner has reached specific conclusions about the present condition and future prospects of the bank, or has noted serious deficiencies or detrimental trends, his or her conclusions and suggestions should be communicated to the bank's senior management, the board of directors, and the Federal Reserve Bank on a timely basis. In formulating discussion and written comments, the examiner should avoid the appearance of second-guessing management. Therefore, conclusions, judgments, and recommendations should be based on objective information generated throughout the entire examination process.

Before preparing examination report comments regarding the overall condition of the bank, the EIC should consider the reporting objective. Once it is determined that problems exist in a bank, the underlying causes must be identified. Those underlying causes as well as specific problems or deficiencies should be covered in the comments. For example, if deficiencies in written lending objectives or policies or noncompliance with sound policies has resulted in the acquisition of sub-quality assets, the examiner's comments must address both cause and effect. The total of classified assets should be cited as evidence of the underlying problem, and appropriate remedies, such as changing objectives or policies, should be suggested.

Examiners should remember that their ability to reach accurate conclusions regarding the overall present condition and future prospects of the bank and their skill in communicating the conclusions to management orally and in reports will, to a great extent, determine the effectiveness of the entire examination process.

The examiner's conclusions regarding the overall condition of the bank are summarized in a composite rating assigned in accordance with guidelines provided under the Uniform Financial Institution Rating System (CAMELS). The composite rating represents an overall appraisal of six key assessment areas (components) covered under the CAMELS rating system: Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. Addi-

tionally, and separate from the interagency UFIRS, the Federal Reserve assigns a Risk Management Rating to all state member banks. The summary, or composite, rating, as well as each of the assessment areas, including risk management, is delineated on a numerical scale of one to five, one being the highest or best possible score. Thus, a bank with a composite rating of one requires the lowest level of supervisory attention, while a five-rated bank has the most critically deficient level of performance and therefore requires the highest degree of supervisory attention. When appraising the six key assessment areas and assigning a composite rating, the examiner weighs and evaluates all relevant factors for downgrades and upgrades of supervisory ratings. (For more information regarding composite rating considerations, see SR-96-38, SR-95-51, SR-16-11, and the appendix section A.5020.1 and also SR-12-4 with regard to CAMELS rating upgrades.) In general, these factors include the adequacy of the capital base, net worth, and reserves for supporting present operations and future growth plans; the quality of loans, investments, and other assets; the ability to generate earnings to maintain public confidence, cover losses, and provide adequate security and return to depositors; the ability to manage liquidity and funding (in particular, during periods of increased financial stress); the ability to meet the community's legitimate needs for financial services and cover all maturing deposit obligations; and the ability of management to properly administer all aspects of the financial business and plan for future needs and changing circumstances. The assessment of management and administration includes the quality of internal controls, operating procedures, and all lending, investment and operating policies; compliance with relevant laws and regulations; and the involvement of the directors, shareholders, and officials.

In addition to the factors discussed above, the EIC should also consider whether risk-management capabilities have improved to address identified principal weaknesses that contributed to the institution's prior ratings, and whether any policies and practices had been implemented that focused on sustainability commensurate with the bank's risk profile. The EIC should also make a determination as to whether the board provided strategic review and oversight of the bank's core financial factors and risk management and if the board actively engaged in the process of correcting deficiencies.

Although the composite rating is based loosely on the average of the six component scores, the examiner's judgment can and should play a major role in its determination. Thus, the examiner must assess the severity, particularly the potential impact, of individual weaknesses on the present and future viability of the bank. Significant problems will provide sufficient basis for deviating from the numerical-average approach to assigning the composite rating. However, whenever deviation from the numerical standards for the composite rating is necessary to accurately reflect the overall condition of the bank, the examiner must provide a full explanation of the reasons for such deviation. See the appendix section A.5020.1 for a complete discussion of the uniform rating system and considerations to be taken into account when using it to evaluate the condition of a bank.

## SUPERVISORY RATINGS UPGRADES

When in a period of stabilized or generally improving economic conditions, there may be some consideration given to ratings upgrades. (See SR-12-4 "Upgrades of Supervisory Ratings for Banking Organizations with \$10 Billion or Less in Total Consolidated Assets.") (See also SR-96-38, SR-95-51, and SR-16-11.)

## SUBSIDIARIES OF BANK HOLDING COMPANIES

The composite rating of an individual subsidiary bank should be based on the condition of that single entity. The quality of management and the financial condition of the consolidated organization will be useful in assessing the prospects and understanding the operations of the bank being examined. However, banks with weaknesses requiring corrective action should be identified as such. Then, appropriate supervisory focus can also be made at the consolidated level. Also, banks should be identified by type on an individual basis rather than by applying the consolidated organization's characteristic to each bank. For example, the capital and condition of a community bank should be judged by community bank standards, not by multinational or regional standards, even if the bank is owned by

such an organization. This approach recognizes that two consolidated organizations of similar size may be composed of entirely different types of banks. Proper evaluation of each bank component should lead a bank holding company examiner to the most appropriate conclusion on the condition of the consolidated entity.

## CONFIDENTIALITY OF THE SUPERVISORY RATING AND OTHER NONPUBLIC SUPERVISORY INFORMATION

A February 28, 2005, interagency advisory reminds banking organizations of the statutory prohibitions on the disclosure of supervisory ratings and other confidential supervisory information to third parties. The agencies<sup>1</sup> learned that some insurers had requested or required banks and savings associations (financial institutions) to disclose their CAMELS rating during the underwriting process when those institutions had sought directors' and officers' liability (D&O) coverage.<sup>2</sup> The agencies responded by issuing the advisory specifically to remind all banking organizations that, except in very limited circumstances, they are prohibited by law from disclosing their CAMELS rating and other nonpublic confidential supervisory information to insurers as well as other nonrelated third parties without permission from their appropriate federal banking agency. (See SR-07-19, SR-05-4, and SR-96-26.)

Federal banking regulations provide that the report of examination, which contains the CAMELS rating, is nonpublic information and is the property of the agency issuing the report.<sup>3</sup> These regulations specifically provide that, except in very limited circumstances, banks and other financial institutions may not disclose a report of examination or any portion of the report, nor make any representations concerning the report or the report's findings, without the

1. The Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC).

2. As part of the examination process, a confidential supervisory rating, called a CAMELS rating, is assigned to each depository institution regulated by the agencies. See the appendix section A.5020.1 for a complete description of the Uniform Financial Institutions Rating System or CAMELS rating system.

3. For the Federal Reserve, see 12 CFR 261.2(c)(1), 261.20(g), and 261.22(e).

prior written permission of the appropriate federal banking agency.<sup>4</sup> The circumstances for release of nonpublic supervisory information may include disclosure to a parent holding company, a director, an officer, an attorney, an auditor, or another specified third party, as indicated in the regulations of the appropriate federal banking agency.<sup>5</sup> Any person who discloses or uses nonpublic information except as expressly permitted by one of the appropriate federal banking agencies or as provided by the agency's regulations may be subject to the criminal penalties provided in 18 USC 641.

The legal prohibition on the release of nonpublic supervisory information applies to all financial institutions supervised by the agencies, including bank, savings and loan, or other holding companies; Edge corporations; and the U.S. branches or agencies of foreign banking organizations, which receive confidential supervisory ratings, including the RFI/C(D) rating, ROCA rating, and CAMEO rating.<sup>6</sup> As with the CAMELS rating, these ratings are transmitted to the regulated institutions in reports of inspection or examination, which are the property of the agencies.

Financial institutions that receive requests for confidential supervisory ratings should refer all requesters to the following publicly available information in lieu of disclosing any confidential regulatory information, including the CAMELS rating. (See the National Information Center, on the Federal Financial Institutions Examination Council (FFIEC) website, <https://www.ffiec.gov>.)

- for banks, an institution's quarterly reports of condition and income (Call Reports) (see 12 USC 1817)

4. See 12 CFR 261.22.

5. See 12 USC 326 and 12 CFR 261.20(b) (exceptions).

6. RFI/C(D), ROCA, and CAMEO ratings are assigned by the FRB as a result of an examination or inspection. As of January 1, 2005, the FRB adopted a new rating system, RFI/C(D) ratings, for bank holding companies. RFI/C(D) ratings components are Risk management, Financial condition, potential Impact of the parent and nondepository subsidiaries on the subsidiary depository institutions, Composite, and Depository institution. For noncomplex bank holding companies with assets of \$1 billion or less, only risk-management and composite ratings are assigned. ROCA ratings are assigned to the U.S. branches, agencies, and commercial lending companies of foreign banking organizations. The ROCA rating components are Risk management, Operational controls, Compliance, and Asset quality. CAMEO ratings are assigned to Edge corporations and the overseas branches and subsidiaries of U.S. banks. The CAMEO ratings components are Capital, Asset quality, Management, Earnings, and Operations and internal controls.

- for holding companies or foreign banks with U.S. operations, an institution's quarterly and annual FR Y or H-(b)11 reports (see 12 USC 1844, 3106, 3108, 601–604a, and 611–631)
- for national banks, the annual disclosure statement (see 12 CFR 18.3)
- for banks, the institution's Uniform Bank Performance Report (UBPR), which is available to all interested parties at the website <https://www.ffiec.gov> and is designed for summary and in-depth analysis of banks
- an institution's publicly available filings, if any, filed with the appropriate federal banking agency (15 USC 78(l)(i)) or with the U.S. Securities and Exchange Commission
- any reports or ratings on the institution compiled by private companies that track the performance of financial institutions<sup>7</sup>
- any reports or ratings issued by private rating services on public debt issued by an institution
- any publicly available cease-and-desist order or enforcement proceeding against an institution<sup>8</sup>
- any reports or other sources of information on institution performance or internal matters created by the institution that does not contain information prohibited from release by law or regulation

## FORMAL AND INFORMAL SUPERVISORY ACTIONS

In general, supervisory action should be considered when other more routine measures, such as formal discussions with a bank's principals or directors and normal follow-up procedures, have failed to resolve supervisory concerns. The Uniform Financial Institution Rating System clearly identifies the more serious problem banks and distinguishes them from banks whose weaknesses or deficiencies are such as to warrant a lower degree of supervisory concern.

For example, the application of prompt and effective remedial action may keep the condition of a composite 3-rated bank from deteriorating and the bank from becoming a problem institu-

7. For bank rating services, see the guidance at <https://www.fdic.gov/bank/index.html>.

8. Information on enforcement actions taken by the Federal Reserve may be found on the Board's public website. Information on enforcement actions taken by other federal agencies, such as the Securities and Exchange Commission, the Financial Crimes Enforcement Network (FinCEN), and the Department of Justice, as well as foreign authorities, may also be publicly available.

tion. To ensure problem areas receive adequate attention, all weaknesses should be clearly defined and corrective measures should be properly structured. This objective may best be achieved through the execution of a memorandum of understanding (MOU) between the bank's board of directors and Reserve Bank officials. In instances where there are only a few minor issues, an informal action such as a commitment letter or a board resolution could be issued. A MOU is not a formal written agreement as prescribed in the Financial Institutions Supervisory Act of 1966 (as amended); it is a good faith understanding between the bank's directorate and the Reserve Bank concerning the principal problems and the bank's proposed remedies. MOUs, commitment letters, and, i.e., Board resolutions, are all normal actions.

Banks rated composite 4 or 5 are clearly problem institutions that require close and constant supervisory attention. Unless specific circumstances argue strongly to the contrary, such banks will be presumed to warrant formal supervisory action, that is, a written agreement or a cease-and-desist order, as provided for in the Financial Institutions Supervisory Act of 1966. In addition, the Board of Governors is authorized to suspend and remove offending officers and directors of banks for certain violations and activities.

Although the decision to pursue formal or informal supervisory actions belongs to the Board of Governors or the Reserve Bank, the initial consideration and determination of whether action is necessary usually results from the examination process. Accurate and complete examination report comments that carefully delineate both the bank's weaknesses and deficiencies, as well as management's existing or planned corrective measures, will allow the Reserve Bank to make the most informed decision concerning appropriate supervisory action. In addition to the results of the examination process leading to an enforcement action, sometimes an enforcement action is the result of an investigation or reporting of a violation of law or regulation.

## CIVIL MONEY PENALTIES

Under provisions of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (P.L. 95-630), the Board of Governors is authorized to assess civil money penalties for violation of the terms of a final cease-and-desist order and violations of—

- sections 19, 22, and 23A of the Federal Reserve Act (respectively, reserve requirements and interest-rate limitations; limitations on loans by insured banks to their executive officers, directors, and principal shareholders; and limits on loans by insured banks to their affiliates);
- the prohibitions of title VIII of FIRA against preferential lending to bank executive officers, directors, and principal shareholders based on a correspondent-account relationship; and
- a willful violation of the change in Bank Control Act of 1978 (12 USC 1817(j)).

In determining the appropriateness of initiating a civil money penalty assessment proceeding, the Board has identified a number of relevant factors (see the June 3, 1998, FFIEC "Interagency Policy Regarding Assessment of Civil Money Penalties" found in the *Federal Reserve Regulatory Service*, 3-1605). In assessing a civil money penalty, the Board is required to consider the size of the financial resources and good faith of the respondent, the gravity of the violation, the history of previous violations, and such other matters as justice may require.

Examiners are responsible for the initial analyses on potential civil money penalties. Civil money penalties should be proposed for serious violations and for violations which, because of their frequency or recurring nature, show a general disregard for the law. After the examiner has reviewed the facts and decided to recommend a civil money penalty, he or she should contact the Reserve Bank for advice on proper documentation and any other assistance.

# Overall Conclusions Regarding Condition of the Bank

## Examination Objectives

Effective date March 1984

## Section 1100.2

---

1. To reach conclusions regarding the present condition of the bank.
2. To reach conclusions regarding the future prospects of the bank.
3. To determine the bank's ability to meet demands in the ordinary course of business or reasonably unusual circumstances.
4. To determine the bank's adherence to safe and sound banking practices.
5. To formulate recommended action, when appropriate, based on those conclusions.
6. To communicate conclusions and recommendations both orally and in the examination report.

# Overall Conclusions Regarding Condition of the Bank Examination Procedures

Effective date May 1988

Section 1100.3

Inasmuch as the following procedures are largely dependent on information generated from all phases of the examination, the examiner-in-charge should complete this program during the final stages of the examination. The completion of this program generally can be best accomplished during the review of the workpapers.

1. Analyze any available information concerning the characteristics of the area in which the bank operates to determine the existence of any unusual situations, any significant trends, the potential impact on the bank of any expected changes or any other significant information which could be detrimental to the bank. The bank should be consulted for sources of information which might include the most recent census data or data generated by organizations, such as the Chamber of Commerce. In analyzing the bank's trade area:
    - a. Consider density, income levels, general age group of the residents. Determine if there are significant changes in any of the above factors.
    - b. Determine the predominant living accommodations in the area (owner occupied vs. rental), price/rent levels and availability of residential units. Determine whether there are any major residential construction projects, re-zoning or conversions of single to multiple units which will have a significant effect on the bank.
    - c. Consider the types of industry and the number of firms in the area with emphasis on determining concentrations or seasonality. Investigate any major labor contract expirations, competitive factors or other significant factors which could have a negative effect on the community.
    - d. Consider the types of major products, available markets and present and projected prices for the products.
    - e. Consider any expected changes in street facilities which will significantly affect bank's accessibility/convenience. Determine the availability of public transportation.
    - f. Review the number and types of institutions that provide similar financial services in the community. Consider the aggressiveness, hours of business and additional services offered by competitor institutions.
  - g. Determine the effect of government employment or dependence on government contracts on the community.
  - h. Consider the condition of the national economy with particular attention to the rate of inflation, national vs. local unemployment, current interest rates and government fiscal and monetary policy. Specific problems, peculiar to a particular area should be investigated more thoroughly.
2. Review comments and conclusions contained in the workpapers which were generated throughout the examination and perform the following:
    - a. Compile all criticisms, exceptions and deficiencies.
    - b. Determine the existence of contradictory conclusions.
    - c. Consider the relative significance of criticisms, exceptions, deficiencies and conclusions and segregate important criticisms for the final review with management and for incorporation into the report of examination.
  3. Based on procedures performed and conclusions contained in the workpapers, answer the following specific questions. These questions are intended as guidelines to the examiner-in-charge in formulating overall conclusions regarding the condition of the bank and should be augmented by the examiner's knowledge of the bank. "Yes" answers, in many instances, evidence the existence of a "leading" indicator of deterioration of bank soundness. For any question with a "yes" answer, specify any mitigating circumstances in the comments column. Sub-question answers are for information purposes.
    - a. *Asset Quality*
      - Is there an increasing ratio of criticized assets to total capital?

- If so, is it indicative of adverse economic conditions, poor credit judgment, or other factors (specify)?
  - Has there been a material increase in the quantity of non-earning assets?
  - Is there any abnormally increasing trend of past-due loans and/or interest earned but not collected?
    - If so, is it indicative of general economic conditions in the bank's trade area
    - Is the trend indicative of a weakening of collection policies and procedures, a slackening of credit standards, the bank's failure to recognize an asset which should be in a non-earning category, or is it caused by some other factor?
  - Has a trend developed wherein the bank assumes increased risk without receiving increased rewards?
  - Do the portfolios exhibit high concentrations in specific industries?
    - If so, do the concentrations represent a significant actual or contingent problem?
  - Has the overall quality of assets deteriorated since the last examination?
    - If so, is the deterioration recognized by management and the board of directors? Can the deterioration be attributed to factors beyond the control of management or the board of directors, such as a change in the general economic conditions of the bank's service area?
      - If deterioration results from internal factors, such as lowering of credit standards or poor credit judgment, have steps been taken by management to effectively reverse negative trends?
- b. *Quality of Management*
- Has the executive management changed since the last examination?
    - If so, is the change detrimental to the bank?
  - Has there been any change in the general banking philosophy of executive management?
    - If so, is that detrimental to the bank?
  - Do key bank officers have educational and/or experience levels below that considered minimal in the circumstances?
  - Is there any tendency toward over reliance on essentially untrained and unskilled clerical staffs?
  - Is there a large disparity between the compensation level of the chief executive officer and other members of executive management?
    - If so, is that disparity an objective indication of disproportional domination of the bank's affairs?
  - Has the bank instituted any systems which directly reward managers for increasing bank income from assets or services subject to their control?
    - If so, has the bank failed to institute necessary control and audit procedures to prevent abuses?
  - Has the bank failed to institute any programs which would give officers a vested interest in remaining with the bank?
    - If so, would the institution of such a program offer a workable solution to an actual or potential officer turnover problem?
  - Is the bank's strategic and operational planning inadequate?
  - Is the board of directors unresponsive to internal or external suggestions for improvement in the bank?
  - Are the following conditions present?
    - Infrequent meetings of board of directors.
    - Infrequent meetings of committees of the board.
    - Infrequent management committee meetings.
    - A directorate which is split into distinct voting groups.
    - If so, are directors viewed as failing to perform their functions adequately?
  - Is the quality of management deemed inadequate to conduct the affairs of the bank in a reasonable and safe manner?
  - Are training programs and compensation increments deemed inadequate to attract and retain a staff capable of providing management succession?

*c. Earnings*

- Are earnings static or moving downward as a percentage of total resources?
- Is there a trend of decreasing income before security gains and losses as a percentage of total revenues?
  - If so, is such a trend expected to continue?
  - If so, has management determined causes for any deterioration and taken action to reverse the negative trend?
- Has the ratio of operating expenses to operating revenues been increasing?
- Are earnings trends consistent?
- Has a decreasing spread between interest earned and interest paid developed?
- Are the bank's earnings significantly vulnerable to changes in interest rate levels?
  - If so, what are management's plans and prospects for altering the vulnerability?
- Are there any significant structural changes in the balance sheet which may impact earnings?
- Has the bank experienced increasing actual loan losses and/or loan loss provisions?
- Is there any evidence that sources of interest and other revenues have changed since that last examination?
  - If so, is that attributed to an unsound emphasis for increased earnings?
- Are earnings deemed inadequate to provide increased capitalization commensurate with the bank's growth?

*d. Capital*

- Has the bank been unable to maintain a normal growth rate for capital?
- Do the ratios of loans to capital, deposits to capital or total assets to capital exhibit a trend to abnormal increases?
- Is capital deemed inadequate to support the present volume of business, including the volume of off-balance-sheet activities, in view of the amount of criticized assets, the competency of management, etc.?

*e. Liquidity*

- Is there a trend toward decreasing bank liquidity?
- Has the bank been forced to increase abnormally dependence on borrowed funds to support existing assets?
- Does the bank depend excessively on purchased funds?
- Is there a trend toward investing interest sensitive liabilities in non-interest sensitive assets?
- Do the present quantity and maturity of non-interest sensitive assets represent a dangerous or potentially dangerous situation?

*f. Off-Balance-Sheet Risk*

## Loans Sold or Serviced

- Is the bank involved as the lead or agent in loan participations, syndications, or servicing activities to the extent that management expertise is inadequate, or to the extent that the volume exceeds the level which management can capably handle?
- Does the bank's record of pending or threatened litigation indicate any instances where the bank, as lead or agent in a loan participation or syndication, has willfully misrepresented the credit to the other participants, or otherwise acted with gross negligence in handling the credit?
  - If so, is there any indication that the participants intend to hold the bank liable for any loss incurred on the credit?
- Did the examination reveal a practice of improper origination and packaging of loans sold or serviced which could cause:
  - The bank being compelled to repurchase the package, or
  - In the case of government guaranteed loans, the complete or partial dishonor of the guaranty?
- Has the bank previously repurchased participations when a loss was incurred, although it was not legally required to do so?

### Letters of Credit

- Is there a trend toward increasing the issuance of standby letters of credit or other similar credit instruments?
  - If so, has the bank failed to consider the full impact of funding a significant percentage of those instruments?
- Are letters of credit excluded from the bank's internal loan review program?
- Does the internal evaluation of letters of credit include consideration of country and currency risk as well as credit risk?
- Is there a declining trend in the credit quality of letters of credit?
- Are standby letters of credit issued for purposes not covered in the bank's lending policy, or for which management does not have the expertise to handle?
- If not authorized in the bank's lending policy, were proper approvals obtained prior to issuance?

### Wire Transfer Department

- Do internal control deficiencies in the wire transfer department pose a threat for large potential losses through fraud or error?
- Are there internal control deficiencies in the receiving and conveying of messages for other parties which may expose the bank to litigation for improper handling of the messages?

### Data Processing Department

- Are internal controls inadequate in the bank's data processing area?
  - Are control deficiencies such that the accuracy and/or timeliness of data is questionable?
  - Are deficiencies such that the bank, in performing data processing services for others, could be liable for misplacement or other improper handling of source data?
- Are the bank's computer hardware and software systems inadequate to support the present and anticipated level of operations?

- Are deficiencies such that hardware and systems will require replacement or upgrading in the short term?

### Settlement Procedures

- If the bank is a member of CHIPS, Fedwire or other clearinghouse system, are procedures inadequate for the proper monitoring of incoming and outgoing wire transfers so that the bank is occasionally unprepared for settlement?
  - Would earnings be significantly affected if the immediate acquisition of funds is required to meet settlement?
  - Is the bank aware of the creditworthiness and ability of the other clearinghouse participants to make settlement?
- Are customers' daylight overdrafts allowed to exceed established credit limits or are they otherwise being improperly monitored?
- Is there a history of daylight overdrafts which have not been covered before the close of business?

### Investment Securities

- Are there significant internal control deficiencies associated with the bank's handling of "when issued" trades, futures contracts and forward placements?
  - Is management's knowledge of interest rate hedging techniques insufficient to support such activity?
- Does the bank act as agent on securities or repurchase agreement transactions?
  - If so, does the customer agreement specifically designate liability for failure or performance?

### Miscellaneous

- Did the analytical review of income and expenses disclose any additional off balance sheet activities for which management does not exhibit the necessary expertise and does not have

adequate internal controls to handle the service?

- Does a review of legal actions against the bank indicate any pattern of practices which are caused by deficient internal controls?
  - If so, have the deficiencies been corrected?
- Is the potential liability arising from pending litigation considered significant in terms of capital adequacy and liquidity, considering the level of other contingent liabilities?
- Are any of the bank's affiliates or subsidiaries experiencing unprofitability or liquidity problems which may affect the soundness of the bank?
- Are operating lease liabilities and annual lease payments significant in terms of the bank's other funding requirements?
- Is potential restitution resulting from Truth in Lending Act violations significant relative to capital and liquidity?
- Is the bank's level of loan commitments, standby letters of credit, commitments to purchase securities and futures/forward contracts imprudent in light of overall circumstances within the bank?

#### g. *Internal Controls and Audit Procedures*

- Have internal controls deteriorated since the last examination?
- Do any of the following exist at the bank?
  - Low compensation level of internal auditors.
  - Internal or external auditor who reports directly to other than the board of directors or a committee thereof.
  - Internal auditors who perform original work versus monitoring the efforts of others.
  - Abnormally low percentage of internal auditors to total personnel.
  - Inadequate training or supervision of internal auditors.
  - Questionable independence of external auditors.

— Inadequate management response to deficiencies cited by auditors.

If so, do these or other pertinent factors indicate a less than adequate situation in internal or external audit?

- Are internal controls and audit programs deemed inadequate?

#### h. *Ownership*

- Have there been significant changes in ownership since the last examination?
  - If so, could the change be detrimental to the soundness of the bank?
- Does any situation exist wherein one individual is capable of controlling the bank?
  - If so, is that detrimental to the bank's soundness?
- Is there any evidence of an impending proxy fight?
- Are ownership interests using borrowed funds to carry the bank's stock?
  - If so, is there an indication that undue pressure for increased earnings is being applied by the owners?
  - If such pressure is being applied, does that have a detrimental impact on the general characteristics of asset composition, as it exists, and asset composition, as it is expected to develop?

#### i. *Miscellaneous*

- Does the bank exhibit a high dependence on purchasing or participating in loans originated and managed by others?
  - If so, is that attributable to a lack of local loan demand or to a failure of the bank to service its trade area?
- Is there an increasing trend toward making loans and/or accepting deposits from outside of areas in which the bank maintains offices?
  - If so, does management and the board fully understand the risks inherent in such activity?
- Has a trend toward increasing advances to affiliated companies developed?

- If so, does that presently represent a dangerous situation?
  - Has the bank experienced an abnormally fast rate of growth?
    - If so, is that growth reasonable and does it therefore, have no significant impact on future soundness, based on:
      - Economic conditions within the trade area?
      - The bank's increased marketing efforts?
      - Offering improved services to the community?
      - Other factors?
    - If so, is the bank's management team capable of adequately administering the growth?
  - Does the bank have an imprudent investment in fixed assets?
  - Does the bank depend to an excessive degree on a small, local economy, which is subject to cyclical swings due to local conditions and industries, as opposed to mirroring national economic trends?
    - If so, is that a source of criticism or does it represent a potentially dangerous situation?
  - Are there large fluctuations in the stock price of the bank or its parent?
    - If so, is management unable to discern a cause for such fluctuations?
  - Is management giving inadequate attention to compliance with laws and regulations?
4. Have all questions raised by the UBPR specialist been explored?
  5. Complete workpapers.
  6. Organize general conclusions regarding the present condition of the bank and:
    - a. Correlate plans, projections, forecasts, and budgets with present conditional aspects, area characteristics, and management capability to determine which of the goals the bank has set you believe to be unattainable.
    - b. Project the future condition of the bank based on its present financial condition, the economic expectations of the bank, the quality of management, director supervision and any other relevant factors.
  - c. Formulate recommendations for management to consider when they initiate corrective or preventative action.
  7. Conduct a final summary discussion with management to include:
    - a. Criticisms noted during the examination.
    - b. Conclusions reached about the bank in general.
    - c. Expected future condition:
      - Management's view.
      - Examiner's view.
    - d. Review of other potential problems.
    - e. Planned corrective action:
      - Examiner recommendations.
      - Management commitments.
  8. Update "Management Assessment" conclusion to add any relevant information obtained as a result of procedures performed in this program.
  9. Prepare recommendations for any necessary supervisory action.
  10. Perform the following steps for suspected violations of criminal statutes:
    - a. Determine that a Criminal Referral Form, FR 2230, has been filed, if appropriate.
    - b. Notify the Reserve Bank by telephone immediately if warranted by the type and seriousness of the suspected violation.
    - c. Prepare a separate memorandum to the Reserve Bank containing sufficient detail to be fully informative.
    - d. Prepare brief comments for the confidential section of the report of examination citing the date of the memorandum to the Reserve Bank.
    - e. Segregate, identify, initial and date all appropriate workpapers and transmit them to the Reserve Bank making certain that the workpapers are factual, complete and do not contain expressions of examiner opinion.
  11. Write, in appropriate report form, all comments and conclusions to be included in the confidential section of the examination report.
  12. Update the workpapers with any information that will facilitate future examinations.

# Uniform Financial Institutions Rating System and the Federal Reserve's Risk Management Rating

Effective date October 2016

## Section 1200.1

### OVERVIEW

Since 1979, state member banks have been rated using the interagency Uniform Financial Institutions Ratings System (UFIRS), which was recommended by the Federal Reserve and other banking agencies. This rating system, referred to industry-wide by the acronym CAMEL, evaluated five components: capital adequacy, asset quality, management and administration, earnings, and liquidity.

Over the years, the UFIRS has proven to be an effective internal supervisory tool for uniformly evaluating the soundness of financial institutions and for identifying those institutions requiring special attention or concern. Recently, the UFIRS was revised and updated to address changes in the financial services industry and in supervisory policies and procedures. The revisions include the addition of a sixth component addressing sensitivity to market risks, explicit reference to the quality of risk-management processes in the management component, and identification of risk elements within the composite and component rating descriptions.

The revisions to UFIRS are not intended to add to the regulatory burden of institutions nor require additional policies or processes. Instead, they are intended to promote and complement efficient examination processes. The revisions have been made to update the rating system, while retaining the basic framework of the original system.

The UFIRS considers certain financial, managerial, and compliance factors that are common to all institutions. Under this system, the supervisory agencies endeavor to ensure that all financial institutions are evaluated comprehensively and uniformly and that supervisory attention is appropriately focused on the financial institutions exhibiting financial and operational weaknesses or adverse trends.

The UFIRS is a useful vehicle for identifying problem or deteriorating financial institutions, as well as for categorizing institutions with deficiencies in particular component areas. Further, the rating system helps Congress follow safety-and-soundness trends and assess the aggregate strength and soundness of the financial industry, which helps the federal banking

agencies in fulfilling their collective mission of maintaining stability and public confidence in the nation's financial system.

### COMPOSITE RATINGS

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

Composite and component ratings are assigned based on a 1-to-5 numerical scale. A "1" is the highest rating, indicating the strongest performance and risk-management practices and the least degree of supervisory concern. A "5" is the lowest rating, indicating the weakest performance, inadequate risk-management practices, and 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 that make up 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 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, as well as the level of supervisory attention warranted.

For this reason, the management component is given special consideration when assigning a composite rating.

Furthermore, the ability of management to identify, measure, monitor, and control the risks of its operations is taken into account when assigning each component rating. Examiners should recognize, 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, 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-to-day 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.

Examiners consider foreign branch and specialty examination findings and the ratings assigned to those areas, as appropriate, when assigning component and composite ratings under UFIRS. The specialty examination areas include Compliance, Community Reinvestment, Government Security Dealers, Information Systems, Municipal Security Dealers, Transfer Agent, and Trust.

Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance. The six key components used to assess an institution's financial condition and operations are capital adequacy, asset quality, management capability, earnings quantity and quality, the adequacy of liquidity, and sensitivity to market risk. The rating scale ranges from 1 to 5, with a rating of 1 indicating the strongest performance and risk-management practices, relative to the institution's size, complexity, and risk profile, and the level of least supervisory concern. A rating of 5 indicates the most critically deficient level of performance; inadequate risk-management practices relative to the institu-

tion's size, complexity, and risk profile; and the level of greatest supervisory concern. The composite ratings are defined below.

### Composite 1

Financial institutions with a composite 1 rating are sound in every respect and generally have components rated 1 or 2. Any identified weaknesses are minor and can be handled routinely by the board of directors and management. These financial institutions are the most capable of withstanding fluctuating business conditions and are resistant to outside influences, such as economic instability in their trade area. These institutions are in substantial compliance with laws and regulations. As a result, they exhibit the strongest performance and risk-management practices relative to their size, complexity, and risk profile, and give no cause for supervisory concern.

### Composite 2

Financial institutions with a composite 2 rating are fundamentally sound. For a financial institution to receive this rating, generally none of its component ratings should be more severe than 3. Only moderate weaknesses are present, and the board of directors and management are capable of and willing to correct them. These financial institutions are stable, can withstand business fluctuations, and are in substantial compliance with laws and regulations. Overall risk-management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

### Composite 3

Financial institutions with a composite 3 rating exhibit some degree of supervisory concern in one or more of the component areas. These institutions have a combination of moderate to severe weaknesses; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate

timeframes. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk-management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure of the institution appears unlikely, however, given its overall strength and financial capacity.

### Composite 4

Financial institutions with a composite 4 rating generally exhibit unsafe and unsound practices or conditions. They have serious financial or managerial deficiencies that result in unsatisfactory performance. The institution's problems range from severe to critically deficient, and weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk-management practices are generally unacceptable relative to the institution's size, complexity, and risk profile. Close supervisory attention is required, which means formal enforcement action is necessary in most cases to address the problems. Institutions in this group pose a risk to the deposit insurance fund. Failure of the institution is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

### Composite 5

Financial institutions with a composite 5 rating exhibit extremely unsafe and unsound practices or conditions. Their performance is critically deficient and risk-management practices are inadequate relative to the institution's size, complexity, and risk profile. These institutions are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assis-

tance is needed for the financial institution to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the deposit insurance fund and their failure is highly probable.

## COMPONENT RATINGS

Each of the component rating descriptions below lists the principal evaluation factors that relate to that component and briefly describes each numerical rating for that component. Some of the evaluation factors appear under one or more of the other components to illustrate the interrelationship among the components. The evaluation factors for each component are not listed in any particular order.

### Capital Adequacy

A financial institution is expected to maintain capital commensurate with its risks and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution's activities will determine the need to maintain capital at levels above required regulatory minimums to properly reflect the potentially adverse consequences of these risks on the institution's capital.

The capital adequacy of an institution is rated based on, but not limited to, an assessment of the following evaluation factors:

- the level and quality of capital and the overall financial condition of the institution
- the ability of management to address emerging needs for additional capital
- the nature, trend, and volume of problem assets, and the adequacy of allowances for loan and lease losses and other valuation reserves
- balance-sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities
- risk exposure represented by off-balance-sheet activities

- the quality and strength of earnings, and the reasonableness of dividends
- prospects and plans for growth, as well as past experience in managing growth
- access to capital markets and other sources of capital, including support provided by a parent holding company

### Ratings

1—A rating of 1 indicates a strong capital level relative to the institution's risk profile.

2—A rating of 2 indicates a satisfactory capital level relative to the institution's risk profile.

3—A rating of 3 indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements.

4—A rating of 4 indicates a deficient level of capital. In light of the institution's risk profile, viability of the institution may be threatened. Assistance from shareholders or other external sources of financial support may be required.

5—A rating of 5 indicates a critically deficient level of capital. The institution's viability is threatened, and immediate assistance from shareholders or other external sources of financial support is required.

### Asset Quality

The asset-quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, other assets, and off-balance-sheet transactions. The ability of management to identify, measure, monitor, and control credit risk is also reflected here. The evaluation of asset quality should consider the adequacy of the allowance for loan and lease losses and weigh the institution's exposure to counterparty, issuer, or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of an institution's assets, including but not limited to oper-

ating, market, reputation, strategic, or compliance risks, should be considered.

The asset quality of a financial institution is rated based on, but not limited to, an assessment of the following evaluation factors:

- the adequacy of underwriting standards, soundness of credit-administration practices, and appropriateness of risk-identification practices
- the level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance-sheet transactions
- the adequacy of the allowance for loan and lease losses and other asset valuation reserves
- the credit risk arising from or reduced by off-balance-sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit
- the diversification and quality of the loan and investment portfolios
- the extent of securities underwriting activities and exposure to counterparties in trading activities
- the existence of asset concentrations
- the adequacy of loan and investment policies, procedures, and practices
- the ability of management to properly administer its assets, including the timely identification and collection of problem assets
- the adequacy of internal controls and management information systems
- the volume and nature of credit-documentation exceptions

### Ratings

1—A rating of 1 indicates strong asset-quality and credit-administration practices. Identified weaknesses are minor and risk exposure is modest in relation to capital protection and management's abilities. Asset quality is of minimal supervisory concern.

2—A rating of 2 indicates satisfactory asset-quality and credit-administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities.

3—A rating of 3 is assigned when asset-quality or credit-administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is generally a need to improve credit-administration and risk-management practices.

4—A rating of 4 is assigned to financial institutions with deficient asset-quality or credit-administration practices. The levels of risk and problem assets are significant and inadequately controlled, and they subject the financial institution to potential losses that, if left unchecked, may threaten its viability.

5—A rating of 5 represents critically deficient asset-quality or credit-administration practices that present an imminent threat to the institution's viability.

## Management

The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities, and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk-exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's activities, management practices may need to address some or all of the following risks: credit, market, operating or transaction, reputation, strategic, compliance, legal, liquidity, and other risks. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls taking into consideration the size and sophistication of the institution; maintenance of

an appropriate audit program and internal control environment; and effective risk-monitoring and management information systems. This rating should reflect the board's and management's ability in relation to all aspects of banking operations as well as other financial-service activities the institution is involved in.

The capability and performance of management and the board of directors is rated based on, but not limited to, an assessment of the following evaluation factors:

- the level and quality of oversight and support of all institution activities by the board of directors and management
- the ability of the board of directors and management, in their respective roles, to plan for and respond to risks that may arise from changing business conditions or the initiation of new activities or products
- the adequacy of and conformance with appropriate internal policies and controls addressing the operations and risks of significant activities
- the accuracy, timeliness, and effectiveness of management information and risk-monitoring systems appropriate for the institution's size, complexity, and risk profile
- the adequacy of audits and internal controls to promote effective operations and reliable financial and regulatory reporting; safeguard assets; and ensure compliance with laws, regulations, and internal policies
- compliance with laws and regulations
- responsiveness to recommendations from auditors and supervisory authorities
- management depth and succession
- the extent that the board of directors and management are affected by or susceptible to dominant influence or concentration of authority
- reasonableness of compensation policies and avoidance of self-dealing
- demonstrated willingness to serve the legitimate banking needs of the community
- the overall performance of the institution and its risk profile

## Ratings

1—A rating of 1 indicates strong performance by management and the board of directors and strong risk-management practices relative to the

institution's size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

2—A rating of 2 indicates satisfactory management and board performance and risk-management practices relative to the institution's size, complexity, and risk profile. Minor weaknesses may exist, but they are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

3—A rating of 3 indicates management and board performance that needs improvement or risk-management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

4—A rating of 4 indicates deficient management and board performance or risk-management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.

5—A rating of 5 indicates critically deficient management and board performance or risk-management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk-management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

## Earnings

The earnings rating reflects not only the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings. The quantity as well as the quality of earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses and require additions to the allowance for loan and lease losses. High levels of market risk may unduly expose the institution's earnings to volatility in interest rates. The quality of earnings may also be diminished by undue reliance on extraordinary gains, nonrecurring events, or favorable tax effects. Future earnings may be adversely affected by an inability to forecast or control funding and operating expenses, improperly executed or ill-advised business strategies, or poorly managed or uncontrolled exposure to other risks.

The rating of an institution's earnings is based on, but not limited to, an assessment of the following evaluation factors:

- the level of earnings, including trends and stability
- the ability to provide for adequate capital through retained earnings
- the quality and sources of earnings
- the level of expenses in relation to operations
- the adequacy of the budgeting systems, forecasting processes, and management information systems in general
- the adequacy of provisions to maintain the allowance for loan and lease losses and other valuation allowance accounts
- the exposure of earnings to market risk such as interest-rate, foreign-exchange, and price risks

## Ratings

1—A rating of 1 indicates earnings that are strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.

2—A rating of 2 indicates earnings that are satisfactory. Earnings are sufficient to support operations and maintain adequate capital and

allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution's level of earnings is adequate in view of the assessment factors listed above.

3—A rating of 3 indicates earnings that need to be improved. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.

4—A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. These institutions may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.

5—A rating of 5 indicates earnings that are critically deficient. A financial institution with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.

## Liquidity

In evaluating the adequacy of a financial institution's liquidity position, consideration should be given to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds-management practices relative to the institution's size, complexity, and risk profile. In general, funds-management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds-management

practices should ensure that liquidity is not maintained at a high cost or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Liquidity is rated based on, but not limited to, an assessment of the following evaluation factors:

- the adequacy of liquidity sources compared with present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition
- the availability of assets readily convertible to cash without undue loss
- access to money markets and other sources of funding
- the level of diversification of funding sources, both on- and off-balance-sheet
- the degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer-term assets
- the trend and stability of deposits
- the ability to securitize and sell certain pools of assets
- the capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds-management strategies, liquidity policies, management information systems, and contingency funding plans

## Ratings

1—A rating of 1 indicates strong liquidity levels and well-developed funds-management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

2—A rating of 2 indicates satisfactory liquidity levels and funds-management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds-management practices.

3—A rating of 3 indicates liquidity levels or funds-management practices in need of improvement. Institutions rated 3 may lack ready access

to funds on reasonable terms or may show significant weaknesses in funds-management practices.

4—A rating of 4 indicates deficient liquidity levels or inadequate funds-management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.

5—A rating of 5 indicates liquidity levels or funds-management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

## Sensitivity to Market Risk

The sensitivity to market risk component reflects the degree to which changes in interest rates, foreign-exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital. When evaluating this component, consideration should be given to management's ability to identify, measure, monitor, and control market risk; the institution's size; the nature and complexity of its activities; and the adequacy of its capital and earnings in relation to the level of market-risk exposure.

For many institutions, the primary source of market risk arises from nontrading positions and their sensitivity to changes in interest rates. In some larger institutions, foreign operations can be a significant source of market risk. For other institutions, trading activities are a major source of market risk.

Market risk is rated based on, but not limited to, an assessment of the following evaluation factors:

- the sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign-exchange rates, commodity prices, or equity prices
- the ability of management to identify, measure, monitor, and control exposure to market risk given the institution's size, complexity, and risk profile

- the nature and complexity of interest-rate risk exposure arising from nontrading positions

- where appropriate, the nature and complexity of market-risk exposure arising from trading and foreign operations

## Ratings

1—A rating of 1 indicates that market-risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk-management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of market risk taken by the institution.

2—A rating of 2 indicates that market-risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk-management practices are satisfactory for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of market risk taken by the institution.

3—A rating of 3 indicates that control of market-risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk-management practices need to be improved given the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital may not adequately support the degree of market risk taken by the institution.

4—A rating of 4 indicates that control of market-risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk-management practices are deficient for the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of market risk taken by the institution.

5—A rating of 5 indicates that control of market-risk sensitivity is unacceptable or that the level of market risk taken by the institution is an imminent threat to its viability. Risk-management practices are wholly inadequate for the size, sophistication, and level of market risk accepted by the institution.

### *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 state member banks, regardless of their size.<sup>1</sup>

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

1—(Strong). A rating of 1 indicates that management effectively identifies and controls all major types of risk posed by the institution’s activities, including those from new products and changing market conditions. The board and management are active participants in managing risk and ensure that appropriate policies and limits exist, and the board understands, reviews, and approves them. Policies and limits are supported by risk monitoring procedures, reports, and management information systems that provide management and the board with the necessary information and analysis to make timely and appropriate responses to changing conditions.

Internal controls and audit procedures are sufficiently comprehensive and appropriate to the size and activities of the institution. There are few noted exceptions to the institution’s established policies and procedures, and none is material. Management effectively and accurately monitors the condition of the institution consistent with standards of safety and sound-

ness and in accordance with internal and supervisory policies and practices. Risk management is considered fully effective to identify, monitor, and control risks to the institution.

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

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

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

The internal control system may be lacking in some important respects, particularly as indicated by continued control exceptions or by the failure to adhere to written policies and procedures. The risks associated with the internal control system could have adverse effects on the safety and soundness of the institution if corrective actions are not taken by management.

---

1. This rating requirement was introduced by SR-95-51, “Rating the Adequacy of Risk Management and Internal Controls at State Member Banks and Bank Holding Companies.”

4—(Marginal). A rating of 4 represents marginal risk management practices that generally fail to identify, monitor, and control significant risk exposures in many material respects. Generally, such a situation reflects a lack of adequate guidance and supervision by management and the board. One or more of the four elements of sound risk management are considered marginal and require immediate and concerted corrective action by the board and management. A number of significant risks to the institution have not been adequately addressed, and the risk management deficiencies warrant a high degree of supervisory attention.

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

seriously affect the safety and soundness of the institution.

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

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