

Foreword

THE CHANGING BANK EXAMINATION ENVIRONMENT

The banking industry continues to be increasingly complex. The changing banking and economic environment may reflect potential risks posed to financial institutions and their subsidiaries, bank-related organizations, consumers, and the public. Other risks may be posed by other types of entities and their subsidiaries, competitors, stakeholders, and other outside third parties. To address the risks, complexity, and competitiveness of the banking industry, Congress and state governments continually approve legislation, and their bank regulatory agencies develop and approve the implementing or other new regulations, all to safeguard the safety and soundness of banks and bank-related organizations.

As part of the Federal Reserve's supervisory process, the banking institution's board of directors or senior management may be requested to initiate various forms of corrective action that may be the result of a supervisory examination or supervisory contact to assure the bank's compliance with federal statutes, regulations, or supervisory policies of the Federal Reserve Board and other federal financial institution regulatory agencies. Banks, bank supervisory agencies and their examiners, and other supervisory staff are constantly confronted with a changing operating environment. Examiners must continually remain alert to unforeseen and unnecessary risks that are posed to, or by, the financial institutions and other bank-related organizations that they may, or may not, supervise and examine. Certain types of activities, transactions, or practices that the bank or other institutions engage in can pose significant risks. The bank's board of directors and senior management are responsible for being aware of, implementing, maintaining, and monitoring adequate internal controls over those risks.

EXAMINATION PROCESS

The state member bank examination process is the Federal Reserve's fact-finding arm in discharging its regulatory and supervisory responsibilities. The essential objectives of an exami-

nation are (1) to provide an objective evaluation of a bank's soundness, (2) to determine the level of risk involved in the bank's transactions and activities, (3) to ascertain the extent of compliance with banking laws and regulations, (4) to permit the Federal Reserve to evaluate the adequacy of corporate governance and to appraise the quality of the board of directors and management, and (5) to identify those areas where corrective action is required to strengthen the bank, improve the quality of its performance, and enable it to comply with applicable laws, regulations, and supervisory policies and guidance. Examiners should also evaluate and determine the prudence of the bank's practices.

An examination's scope is primarily risk-focused but may cover every phase of banking activity, or it may concentrate on specific areas that deserve greater emphasis because of their potential effect on a bank's soundness. The scope and planning for a bank's examination is an integral and important part of the overall examination process. With the enactment of new laws and regulations and the issuance of additional guidance, the scope of an examination continually expands to ensure that all new and existing functional risk areas of a bank are adequately reviewed. New laws, regulations, supervisory policies, guidance, and interpretations result from emerging issues within the banking industry or are tied to specific industry events.

To assess the bank's performance and summarize its overall condition, examiners use the Uniform Financial Institutions Rating System (UFIRS), which is commonly referred to as the CAMELS rating system. The examiner's primary objectives are to evaluate the (1) quality and adequacy of the bank's capital (C); (2) the quality of the bank's assets (A); (3) the capability of the board of directors and management (M) to identify, measure, monitor, and control the risks of the bank's activities and to ensure that the bank has a safe, sound, and efficient operation that is in compliance with applicable laws and regulations; (4) the quantity, sustainability, and trend of the bank's earnings (E); (5) the adequacy of the bank's liquidity (L) position; and (6) the bank's sensitivity (S) to market risk—the degree to which changes in interest rates, foreign-exchange rates, commodity prices, or equity prices can adversely affect the bank's earnings, capital, and liabilities sub-

ject to market risk. Once this process is completed, examiners will have the basis for rating the CAMELS components, which, in turn, provide the basis for assigning the bank's overall composite rating. Evaluations of the components are to take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile. During the examination, examiners evaluate the nature of the bank's operations, the adequacy of the bank's internal controls and its internal audit function, and the bank's compliance with laws and regulations.

RISK-FOCUSED EXAMINATION PROCESS

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 state member banks. There was an increased emphasis on establishing, maintaining, and monitoring of internal controls. System examination staff were also instructed to assign a formal supervisory rating to the adequacy of a state member bank's risk management and internal control processes. The greater focus on risk management did not diminish the importance of assessing the CAMELS components. Rather, the rating of risk management summarized much of the analysis and findings regarding the member bank's process for monitoring and controlling risks in these other key areas. As a result, the assigned risk-management rating highlights and incorporates further the qualitative and quantitative aspects of the examiners' review of the bank's overall process for identifying, measuring, monitoring, and controlling risk throughout the institution.

Greater emphasis on risk-focused supervision continued in 1997 when the Federal Reserve introduced its risk-focused framework for the supervision of large complex institutions. Supervisory processes were designed to focus more effectively on an organization's primary risks and internal controls and the processes for managing and monitoring principal risks. The framework pertained to institutions with a functional management structure and a broad array of products, services, activities, and operations. This program is managed by an assigned central point of contact (CPC), assisted by a dedicated

team of examiners who conduct target reviews of functional areas and product lines during a supervisory cycle.

A supervisory framework also was begun for community banks. The framework relies on examiner judgment when determining the scope of the examination during the planning process. Examiners are able to customize the examination procedures to be performed on-site at the bank. The examiner-in-charge (EIC) outlines the risk profile of the bank and the examination activities.

ABOUT THIS MANUAL

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

- determining the scope of an examination;
- determining the procedures to be used in examining all areas of a bank, including those procedures that may lead to the early detection of trends that, if continued, might result in a deterioration in the condition of a bank;
- evaluating the adequacy of the bank's written policies and procedures, the degree of compliance with them, and the adequacy of its internal controls;
- evaluating the work performed by internal and external auditors;
- evaluating the performance and activities of management and the board of directors;
- preparing workpapers that support examination reports and aid in evaluating the work performed; and
- using objective criteria as a basis for the overall conclusion and for the resulting comments and criticism, regarding the condition and quality of the bank and its management.

The CPC or EIC must properly plan and organize the examination before work begins. Initial decisions concerning examination scope can usually be made based on the nature of the bank's operations; its size; the past experience of the CPC or EIC with the bank; the previous examination report's information, including the condition of the bank at that examination; com-

munications with the bank (e.g., the board of directors and senior management) between examinations; and analysis of the information derived from the bank's Uniform Bank Performance Report, Call Report, or off-site surveillance screening of data. The planning of work and pre-examination procedures are covered in the Examination Planning section of this manual.

The manual is also intended to guide examiners in their efforts to encourage banks to develop written policies and related procedures in all areas where none exist, and to correct situations where there are deficiencies in, or a lack of compliance with, existing procedures. To aid examiners, this manual includes topics such as loan portfolio management, investment portfolio management, asset and liability management, earnings analysis, capital analysis, and service area analysis. A section on the appraisal of bank management guides examiners in assembling and evaluating information from all other manual sections and helps uncover inconsistencies in the application of bank policies among various management groups. Examiners should be able to increase the level of professionalism and the soundness of the banking system by encouraging all banks to follow the best practices that currently exist in the banking industry. However, this approach should not discourage the development and implementation of conceptually sound and innovative practices by individual banks.

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

Examiners should view the manual as a working tool and guide. In most sections of the manual, examination procedures and internal control questionnaires are provided to form the basis for a bank examination. These procedures should lead to consistent and objective examinations of varying scope. The bank's condition is disclosed by the performance of the examination procedures, including the review of internal

controls and audit function, and the evaluation of the results or findings, not by the examiner's judgment alone.

HOW TO USE THIS MANUAL

Organization

The *Commercial Bank Examination Manual* is divided into 10 major parts, separated by divider tabs:

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

Sections in each part are made up of four subsections, where applicable:

- supervisory policy and guidance by topic,
- examination objectives,
- examination procedures, and
- internal control questionnaire

The primary sections summarize and provide details on the respective topics. This information is expanded upon and reinforced through the Federal Reserve's educational and training programs and the examiner's experience on the job.

The examination objectives describe the goals that should be achieved, which should be of primary interest to the examiner. Two of the objectives may determine the scope of the examination for the specific area of examination interest: (1) the evaluation of the system of internal controls and of bank policies, practices, and procedures and (2) the evaluation of the scope and adequacy of the audit function. Other common objectives are to determine compliance with laws, regulations, supervisory policies, procedures, guidance, and any interpretations, and to determine the need for corrective action.

The examination procedures include proce-

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

The evaluation of a bank's internal control environment should encompass a review of the internal audit activities and the implementation of selected internal control questionnaires (ICQs), which set forth standards for operational control. Due to the difference between an examination and an audit, it is not anticipated that every ICQ will be applied. ICQs used during an examination should be made up of three elements: (1) those mandated for all examinations; (2) those selected by the CPC or EIC based upon his or her experience, knowledge of problems within the bank, and perception and analysis of risk; and (3) those that focus on areas where on-site evaluation of operational control appears warranted in light of the results of the examination of internal audit activities. In addition to serving as a guide during on-site evaluations, the ICQs can be used in the appraisal of operational audit techniques in banks where the scope of internal auditing includes such considerations. The ICQ steps marked with an asterisk require substantiation by observation or testing; they are considered fundamental to any control program regardless of the size of the institution. These steps should be incorporated in management control programs in smaller banks to compensate for the absence of internal auditing.

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

Numbering System

The manual is arranged using a numbering system based on the manual's sections and subsections. For example, the primary Internal Controls section is numbered 1010.1. The examination objectives subsection for that section is numbered 1010.2, and so on. Subsections are usually numbered consecutively regardless of the number of subsections within a particular section.

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

Updates

Subsequent to the March 1994 reprint of this manual, all new or revised manual pages are dated the month and year for which they were issued. There is an effective date at the top of the first page of each section that shows when the section's information was last updated.

The manual is usually updated in the spring and fall of each year; special supplements may be issued if needed. On the back of the title page is a checklist so you can record when an update has been filed. For this manual to be most useful, it is essential that updated pages be filed as soon as possible. The most recent version of the manual is also available on the Board's website at www.federalreserve.gov/publications/supmanual.htm. If you have any questions about receiving updates, please contact Printing and Fulfillment, Mail Stop K1-120, Board of Governors of the Federal Reserve System, Washington, DC 20551, (202) 452-3245, or at www.federalreserve.gov/files/orderform.pdf.