Office of Inspector General

Office of Audits and Evaluations
Report No. AUD-12-011

The FDIC's Examination Process for Small Community Banks

August 2012

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Executive Summary

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Why We Did The Audit

On February 10, 2012, the Chairman of the United States Senate Committee on Banking, Housing, and Urban Affairs requested that the Inspectors General of the FDIC, the Department of the Treasury, the Board of Governors of the Federal Reserve System, and the National Credit Union Administration conduct audits of their respective agencies' examination processes for small community banks and credit unions. The Chairman's request was prompted by concerns from community banks and credit unions that examinations were being conducted without clear standards or consistent application of agency policies and procedures, which could discourage business growth and responsible lending. The request indicated that the results of the audits would help the Committee to better understand the supervisory processes at the agencies and facilitate the Committee's efforts to address concerns raised by community banks and credit unions.

The objectives of our performance audit were to report on: (1) the FDIC's examination process for small community banks, including examination timelines and how the FDIC ensures consistency in the administration of examinations across the country, and (2) the ability of FDIC-supervised institutions to question examination results, such as through the Office of the Ombudsman (OO), the appeals process, or informal channels, and the frequency and success of such appeals. The scope of our review, 2007-2011, was selected to take into account examination timeframes and appeals processes both before and during the financial crisis. The audit did not include an assessment of the adequacy or the effectiveness of these processes.

Background

Bank supervision and consumer protection are cornerstones of the FDIC's efforts to ensure the stability of, and public confidence in, the nation's financial system. The FDIC's supervision and consumer protection programs promote the safety and soundness of FDIC-supervised institutions, help protect consumer rights, and further community investment initiatives. As of December 31, 2011, the FDIC was the primary federal regulator for 4,598 state-chartered financial institutions that were not members of the Federal Reserve System. A total of 4,293 (or 93 percent) of these institutions were small community banks with assets totaling $1 billion or less.

Within the FDIC, the Division of Risk Management Supervision (RMS) has primary responsibility for the safety and soundness of FDIC-supervised institutions. RMS conducts onsite risk management examinations of institutions to assess their overall financial condition, management practices and policies, and compliance with applicable laws and regulations. During 2011, RMS conducted 2,712 statutorily-required risk management examinations. RMS also conducts specialty examinations that cover such areas as trust department operations, information technology controls, and institution compliance with the Bank Secrecy Act. During 2011, RMS conducted 6,002 specialty examinations. The FDIC's Division of Depositor and Consumer Protection (DCP) has primary responsibility for protecting consumer rights. DCP conducts onsite examinations of institutions to assess compliance with consumer protection laws and regulations and the extent to which institutions meet community needs under the Community Reinvestment Act (CRA). During 2011, DCP conducted 1,757 CRA/compliance examinations. In addition, the FDIC's Office of Complex Financial Institutions (OCFI) has primary responsibility for providing a comprehensive focus on the supervisory, insurance, and resolution risks presented to the FDIC by the largest and most complex financial institutions.

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Audit Results

The FDIC has established and implemented a nationwide program for planning, conducting, reporting, and evaluating the effectiveness of its examinations of FDIC-supervised community institutions. With respect to examination timelines, the risk profile of every bank is different, even within a similar size range and rating, so actual examination hours and timeframes can vary. We did find that, in broad terms, the cycle time for conducting risk management examinations increased significantly as the supervisory ratings for, and condition of, the institution deteriorated. We also noted that overall cycle time for well-rated institutions (1 or 2 ratings) increased to a limited degree during the period covered by our review, which the FDIC attributed to policy changes that increased baseline procedures and allowed for more examiner discretion in expanding the scope of their examinations, based on identified risks.

As it relates to the time it takes the FDIC to issue an examination report following onsite work, that phase of the examination process generally ranged from:

- 2 to 4 weeks for institutions rated 1 or 2; and
- 6 to 9 weeks for institutions rated 3, 4, or 5.

The difference in report processing timeframes can generally be attributed to the additional complexity and volume of deficiencies associated with troubled institutions, the level of review required to ensure the reports fully support lower ratings and appropriate supervisory actions, and examiners working with bank management and other regulatory agencies to reach agreement on the examination findings and supervisory actions before the final report is issued.

We also collected examination timeline statistics for compliance examinations. Generally, we identified a trend similar to what we found with risk management examinations—longer overall cycle times for lower-rated institutions. However, unlike risk management examinations, elapsed days between onsite examination work and the issuance of the final report did not vary much according to ratings from 2009 forward, averaging about 1 month.

Regarding how consistently the FDIC administers examinations in its various regions, the FDIC has established the following controls and practices intended to promote a consistent examination process while being mindful that examiners must consider unique circumstances and risk factors associated with each institution:

- Examination policy and guidance.
- Training programs for examiners.
- Multiple levels of review for examination reports, including in certain circumstances by headquarters officials.
- Standards and guidance for applying supervisory actions.
- Quality control reviews of key regional and field office examination activities.
- Coordination with other federal and state regulatory agencies on matters of mutual interest.

Concerning the ability of FDIC-supervised institutions to question examination results, the FDIC encourages examiners and bankers to make a good-faith attempt to resolve disputes through informal dialogue during the examination. According to FDIC officials, many disputes are successfully resolved in this manner. Other opportunities for such a dialogue include exit meetings with bank management, discussions during the reporting process to clarify issues, and meetings with an institution's board of directors at which the examination results are presented. The FDIC also asks each institution, at the end of a risk management examination, to complete a Post-Examination Survey to help the FDIC in improving the efficiency and quality of its examinations.

When agreement on key issues such as examination ratings, loan loss reserve provisions, or classifications of significant loans cannot be reached informally, institutions may request a formal review by the Director of RMS, DCP, or OCFI, as appropriate. A total of 41 such requests were made during the 5-year period ended December 31, 2011. Of this number, one was sustained and three were partially sustained. According to FDIC officials, few requests for review are sustained because the applicable Director usually finds that the initial determinations are consistent with FDIC policy.

Institutions that dispute the results of the directors' reviews may appeal to the Supervision Appeals Review Committee (SARC), which is outside of the examination and supervision process. The SARC's decisions on material supervisory determinations are final. A total of 23 appeals were filed with the SARC during the 5-year period ended December 31, 2011. Of this number, one appeal was partially sustained. The remaining appeals were either denied or lacked grounds for an appeal to the SARC. In reviewing the SARC determinations for appeals that were denied, we noted that the SARC considered the underlying merits of both the institutions' and the examiners' positions and, as such, considered the substance of the disagreement, and not simply whether or not the examiners followed established policy.

In addition, bankers may question examination results in enforcement action cases filed by the FDIC with the Office of Financial Institution Adjudication (OFIA) administrative law judge, who conducts hearings and recommends decisions associated with formal enforcement actions. Bankers may also contact the FDIC's OO, which can be used to discuss and resolve concerns associated with any aspect of the examination process in a confidential forum.

Finally, while not directly related to the objectives of our audit, our report discusses various FDIC initiatives used to further its dialogue and efforts to better understand the challenges and opportunities facing community banks. Such actions help to ensure that the FDIC and others significant to the financial industry identify and discuss community banking-related issues and take action to address those issues.

Corporation Comments

Subsequent to the issuance of our draft report, FDIC officials provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On August 29, 2012, the RMS Director provided a written response to a draft of this report on behalf of the Corporation. That response is provided in its entirety in Appendix 9.

In the response, the RMS Director noted the thoroughness of the draft report and concurred with our observations about increased examination cycle and report processing timeframes. The Director also acknowledged the information in the report regarding quality control practices that promote consistency in the examination process and encourage examiners and bankers to informally resolve disputes during examinations. Concerning our observations on the formal dispute resolution process, the Director confirmed that changes to the decisional deadlines have enabled formal reviews and appeals to be processed within applicable timeframes.

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Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, Virginia 22226 Office of Inspector General

DATE: August 31, 2012

MEMORANDUM TO: Martin J. Gruenberg
Acting Chairman

/Signed/
FROM: Jon T. Rymer
Inspector General

SUBJECT: *The FDIC's Examination Process for Small Community Banks* (Report No. AUD-12-011)

This report presents the results of our audit of the FDIC's examination process for small community banks. We initiated this audit in response to a request, dated February 10, 2012, from the Chairman of the United States Senate Committee on Banking, Housing, and Urban Affairs (SBC Chairman) to the Inspectors General of the Department of the Treasury (Treasury), the Board of Governors of the Federal Reserve System (FRB), the FDIC, and the National Credit Union Administration (NCUA). The Chairman's request was prompted by concerns from community banks and credit unions that examinations were being conducted without clear standards or consistent application of agency policies and procedures, which could discourage business growth and responsible lending. The request indicated that the audit results would help the Committee to better understand the federal banking agencies' supervisory processes and facilitate efforts to address concerns raised by community banks and credit unions.

The Treasury, FRB, and NCUA Inspectors General also initiated audits at their respective agencies in response to the SBC Chairman's request. We coordinated our audit scope and methodology with the other Inspectors General.

Although the SBC Chairman's request specifically focused on small community banks and credit unions, the federal banking agencies do not have a standard definition for what constitutes "small" community banks. Therefore, for the purposes of this report, we focused primarily on the processes applicable to "community institutions," which are generally defined by the federal banking agencies as having less than $1 billion in total assets.

Consistent with the SBC Chairman's request, the audit objectives were to report on:

1. the FDIC's examination process for small community banks, including examination timelines and how the FDIC ensures consistency in the administration of examinations across the country; and

2. the ability of FDIC-supervised institutions to question examination results, such as through the Office of the Ombudsman (OO),[1] the appeals process, or informal channels, and the frequency and success of such appeals.

To address our objectives, we collected and summarized relevant information on the FDIC's examination processes and the various means available to FDIC-supervised institutions to appeal or question examination results. The scope of our review, 2007-2011, was selected to take into account examination timeframes and appeals processes both before and during the financial crisis. We confirmed the completeness of the information we collected with FDIC divisions and offices; however, our audit did not include an assessment of the adequacy or effectiveness of these processes.

We conducted this performance audit in accordance with generally accepted government auditing standards. Appendix 1 of this report includes additional details on our objectives, scope, and methodology. Appendices 2-6 provide overviews of the FDIC's examination processes, laws and rules and regulations applicable to examination and supervision activities, examiner and financial institution guidance, examiner training activities, and the Federal Financial Institutions Examination Council's[2] (FFIEC) task forces. Appendix 7 contains a glossary of key terms, and Appendix 8 contains a list of acronyms. The Corporation's comments on our report are presented in Appendix 9

Background

The purpose of federal bank supervision is to ensure that institutions throughout the financial system are operating in a safe and sound manner and complying with banking laws and regulations in the provision of financial services. FDIC-insured institutions are supervised by one of three federal banking agencies, as follows:

- The FDIC supervises all state-chartered banks and thrifts that are not members of the Federal Reserve System.
- The FRB supervises state-chartered commercial banks that are members of the Federal Reserve System.
- The Office of the Comptroller of the Currency (OCC) supervises all federally-chartered banks and thrifts.

The FDIC and FRB share supervision of state-chartered banks and thrifts with the state banking departments. In doing so, the federal and state regulators coordinate their supervisory programs and, in many instances, alternate examinations or conduct joint examinations. Higher-level coordination between the federal banking agencies and the

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[1] See http://www.fdic.gov/regulations/resources/ombudsman/index.html for additional information on the FDIC's OO.
[2] Certain terms that are underlined when first used in this report are defined in Appendix 7, *Glossary of Terms*.

states on policy matters is conducted through various channels, including the FFIEC and the Conference of State Bank Supervisors (CSBS).

The FFIEC is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the FDIC, FRB, OCC, NCUA, and the Consumer Financial Protection Bureau (CFPB) and to make recommendations to promote uniformity in the supervision of financial institutions. In 2006, the State Liaison Committee (SLC) was added to the FFIEC. The SLC was established by the FFIEC to encourage the application of uniform examination principles and standards by state and federal agencies and to allow state regulators to participate in the development of those principles and standards. The SLC includes representatives from the CSBS, the American Council of State Savings Supervisors, and the National Association of State Credit Union Supervisors.

Bank supervision and consumer protection are cornerstones of the FDIC's efforts to ensure the stability of, and public confidence in, the nation's financial system. The FDIC's supervision and consumer protection programs promote the safety and soundness of FDIC-supervised institutions, help protect consumer rights, and further community investment initiatives. As of December 31, 2011, the FDIC was the primary federal regulator for 4,598 state-chartered financial institutions that were not members of the Federal Reserve System. A total of 4,293 (or 93 percent) of these institutions were small community banks with assets totaling $1 billion or less. The number and total assets of U.S. institutions supervised by each federal regulator are shown in Table 1 below.

Table 1: U.S. Institutions Supervised by the FDIC, FRB, and OCC as of 12/31/2011*

Federal Regulator	Total U.S. Institutions	Total Community Institutions	Total Institution Assets***	Total Community Institution Assets***
FDIC**	4,598	4,293	$2,341	$864
FRB	828	724	1,891	170
OCC**	1,931	1,683	9,651	385
Total	**7,357**	**6,700**	**$13,883**	**$1,419**

Source: FDIC Division of Insurance and Research (DIR), *Quarterly Banking Profile, Fourth Quarter 2011*, and *Smaller Bank Profile, Fourth Quarter 2011*.

* This table excludes the domestic branches of foreign banks operating in the United States.

** In accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), the former Office of Thrift Supervision transferred primary oversight responsibilities for thrift institutions to the FDIC and OCC in July 2011.

*** Institution assets are presented in billions of dollars.

From 2007 to early 2011, one FDIC division was responsible for conducting all examinations—the Division of Supervision and Consumer Protection (DSC). In February 2011, the FDIC implemented an organizational change that re-designated DSC as the Division of Risk Management Supervision (RMS), responsible for risk management and specialty examinations. At the same time, the FDIC transferred responsibility for conducting compliance and Community Reinvestment Act (CRA) examinations to a new division—the Division of Depositor and Consumer Protection (DCP). In addition, the Office of Complex Financial Institutions (OCFI) was created to provide a comprehensive focus on the supervisory, insurance, and resolution risks presented to the FDIC by the largest and most complex financial institutions.

Audit Results

The FDIC has established and implemented a nationwide program for planning, conducting, reporting, and evaluating the effectiveness of its examinations of FDIC-supervised community institutions. With respect to examination timelines, the risk profile of every bank is different, even within a similar size range and rating, so actual examination hours and timeframes can vary. We did find that, in broad terms, the cycle time for conducting risk management examinations increased significantly as the supervisory ratings for, and condition of, an institution deteriorated. We also noted that overall cycle time for well-rated institutions (1 or 2 ratings) increased to a limited degree during the period covered by our review, which the FDIC attributed to policy changes that increased baseline procedures and allowed for more examiner discretion in expanding the scope of their examinations, based on identified risks.

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- Multiple levels of review for examination reports, including in certain circumstances by headquarters officials.
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Concerning the ability of FDIC-supervised institutions to question examination results, the FDIC encourages examiners and bankers to make a good-faith attempt to resolve disputes through informal dialogue during the examination. According to FDIC officials, many disputes are successfully resolved in this manner. Other opportunities for such a dialogue include exit meetings with bank management, discussions during the reporting process to clarify issues, and meetings with an institution's board of directors (BOD) at which the examination results are presented. The FDIC also asks each institution, at the end of a risk management examination, to complete a Post-Examination Survey to help the FDIC in improving the efficiency and quality of its examinations.

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In addition, bankers may question examination results in enforcement action cases filed by the FDIC with the Office of Financial Institution Adjudication (OFIA) administrative law judge (ALJ), who conducts hearings and recommends decisions associated with formal enforcement actions. Bankers may also contact the FDIC's OO, which can be used to discuss and resolve concerns associated with any aspect of the examination process in a confidential forum.

Finally, while not directly related to the objectives of our audit, our report discusses various FDIC initiatives used to further its dialogue and efforts to better understand the challenges and opportunities facing community banks. Such actions help to ensure that the FDIC and others significant to the financial industry identify and discuss community banking-related issues and take action to address those issues.

The FDIC's Oversight of Community Banks

Although community institutions with under $1 billion in assets hold less than 11 percent of total banking assets, they provide 37 percent of the loans made by the banking industry to small businesses.[3] The FDIC serves as the primary federal regulator for the majority of community institutions in the nation.

The FDIC's supervision program, administered by RMS and DCP, promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised institutions. RMS has primary responsibility for promoting safe and sound financial institution practices through:

- periodic, onsite risk management examinations;
- offsite monitoring,[4] including the review of quarterly financial data;
- the issuance of supervisory and enforcement actions;
- the publication of guidance and policy;
- ongoing communications with industry officials; and
- the review of applications submitted by FDIC-supervised institutions.

RMS also conducts specialty examinations, usually performed during risk management examinations, that cover trust department operations, information technology controls, and institution compliance with the Bank Secrecy Act (BSA).

DCP conducts separate examinations to assess an institution's compliance with consumer protection statutes and regulations for all state nonmember banks supervised by the FDIC.[5] DCP also conducts CRA examinations for all state nonmember banks to assess the extent to which an institution is meeting community needs. As part of the compliance examination process, the FDIC reviews substantive compliance issues as well as the accuracy and completeness of information and disclosures that institutions provide to consumers.

Table 2 provides statistics on the number and types of examinations conducted by the FDIC in 2011.

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[3] This information was provided by the FDIC's DIR, as of March 31, 2012.
[4] The FDIC's offsite review program is designed to identify emerging supervisory concerns and potential problems so that supervisory strategies can be adjusted appropriately. For example, offsite reviews are performed quarterly for each bank that appears on the Offsite Review List. Regional management is responsible for implementing procedures to ensure that Offsite Review findings are factored into examination schedules and other supervisory activities.
[5] For FDIC-supervised banks under the primary jurisdiction of the CFPB, DCP officials stated that their review is limited to the laws and regulations not enumerated in the Dodd-Frank Act.

Table 2: FDIC Examinations, 2011

Examination Type	2011
Risk Management:	
State Nonmember Banks	2,477
Savings Banks	227
State Member Banks*	4
National Banks*	1
Savings Associations*	3
Subtotal	**2,712**
Compliance/CRA:	
Compliance-only	921
Compliance/CRA	825
CRA-only	11
Subtotal	**1,757**
Specialty:	
Trust Department Operations	466
Information Technology Controls	2,802
Compliance with BSA	2,734
Subtotal	**6,002**
Total	**10,471**

Source: FDIC 2011 Annual Report.

* The FDIC may conduct examinations of state member banks, national banks, and savings associations, when needed for insurance purposes.

More information on the FDIC's processes for risk management and compliance/CRA examinations can be found in Appendix 2.

Examination Timelines

Tracking and Measuring Examination Timeframes

Although the FDIC has performance goals applicable to its various examination functions, we were informed by RMS senior management that they currently do not have specific goals for examination timeframes,[6] lest they create incentives that may cause examiners to curtail work to meet time budgets when encountering potential problems. Instead, the examination team should contact their field and/or regional management when problems are encountered and additional time is needed to complete the examination beyond the budget developed during pre-examination planning.

Despite the absence of goals for examination timeframes, the FDIC does track key dates for all risk management and compliance examinations, including:

- Examination Start Date, which is the date the examination team begins onsite work;

[6] We found that the FDIC did have timeframe goals for compliance/CRA examinations in 2010 and 2011. For more details on these goals, see page 15 in this report.

- Date Examination Completed, which is the date the examination team leaves the bank and submits a draft examination report for supervisory review; and
- Date Mailed, which is the date the final report is mailed to the institution.[7]

Using these key dates, the FDIC tracks and monitors the time spent by the examination team for fieldwork and report processing.

In addition, the FDIC has benchmarks that are used to project staffing requirements. The benchmarks are estimates of staff hours for an average risk management examination of banks by asset size and CAMELS[8] ratings. According to RMS, the risk profile of every bank is different, even within a similar size range and rating, so RMS managers expect to see actual examination hours vary from applicable benchmarks.

The current benchmarks used by RMS for risk management examinations range, as shown in Table 3, from 335 hours to 1,820 hours for institutions with up to $1 billion in assets, depending on asset size and ratings.

Table 3: Risk Management Examination Benchmarks

Asset Size ($ millions)	CAMELS Composite Rating of 1 or 2*	CAMELS Composite Rating of 3*	CAMELS Composite Rating of 4 or 5*
Under 50	335	515	720
50-100	455	690	975
100-150	520	795	1,120
150-200	575	870	1,225
200-250	605	915	1,285
250-500	710	1,070	1,500
500-1,000	850	1,295	1,820

Source: RMS Business Analysis and Decision Support Section.

* Each benchmark represents examination hours for a risk management examination of an FDIC-supervised institution with the associated asset size and rating.

The current benchmarks used by DCP for compliance/CRA examinations are shown in Table 4 for institutions with up to $1 billion in assets:

[7] DIR uses the examination mail date (also referred to as the "transmittal date") to determine when deposit insurance assessment pricing changes become effective for financial institutions. See the FDIC OIG's audit report, *Reliability of Supervisory Information Accessed Through the Virtual Supervisory Information on the Net (ViSION) System* (AUD-08-019, dated September 25, 2008), for more information.

[8] Examiners review the institution's risk exposure in six component areas, using what is known as the Uniform Financial Institution Rating System (UFIRS), commonly referred to as the CAMELS rating system -- (**C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to market risk). Evaluations of CAMELS components consider the institution's size and sophistication, the nature and complexity of its activities, and its risk profile. At risk management examinations, an institution is rated for each of the CAMELS components and assigned a composite rating, which generally bears a close relationship to the component ratings. The component and composite ratings are scored on a scale of 1 (best) to 5 (worst).

Table 4: Compliance/CRA Examination Benchmarks

Asset Size ($ millions)	Compliance-Only Examinations*	CRA-Only Examinations*	Joint Compliance/CRA Examinations*
Under 50	170	55	225
50-100	215	65	280
100-250	250	95	345
250-500	320	130	450
500-1,000	380	175	555

Source: RMS Business Analysis and Decision Support Section.

* Each benchmark represents examination hours for a compliance and/or CRA examination of an FDIC-supervised institution with the associated asset size.

We noted that RMS maintains tracking data on the actual hours spent on each examination by examination type and by asset size and ratings categories. This information is used to show the range of examination hours above and below the benchmarks and to report average examination hours, by region, compared to each benchmark category. RMS managers use these reports to monitor examination staff hours against the benchmarks to detect trends and plan future staffing needs.

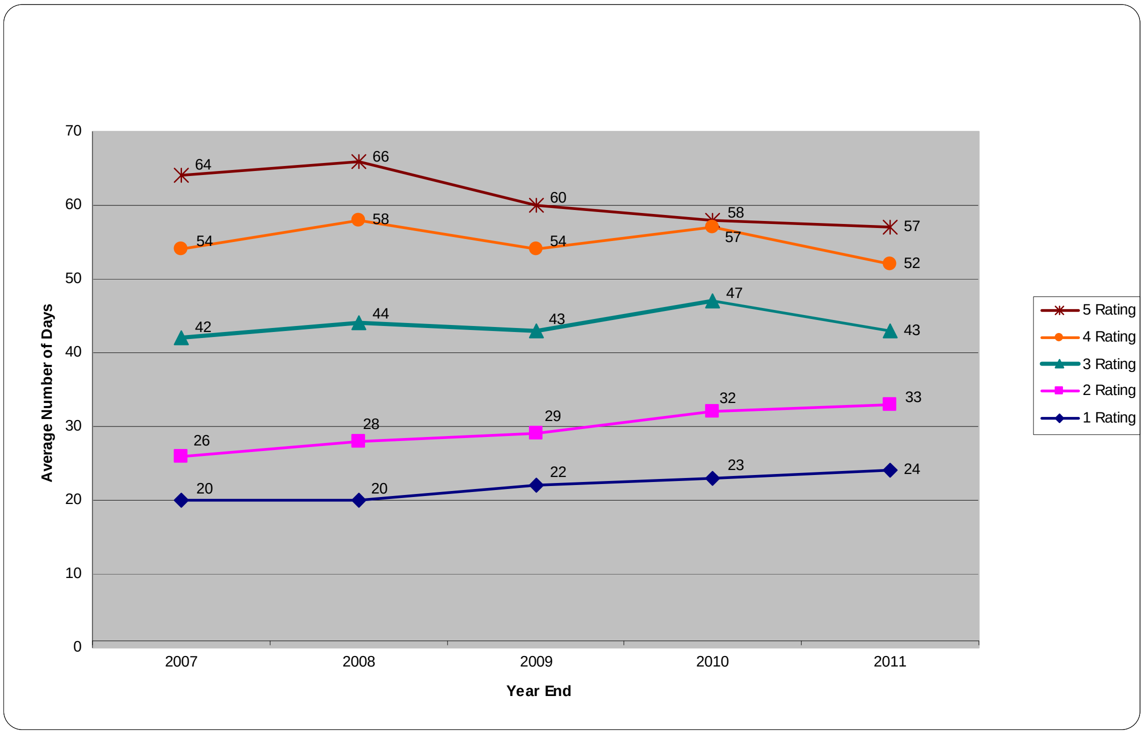
The Examination Process Tied to Available Timeframe Data

For both risk management and compliance examinations, RMS also maintains tracking information from the start to the end of onsite fieldwork and to the issuance of the final examination report. The following sections present statistical data on the average turnaround times, in days, for risk management and compliance examinations.[9] The scope of our review, 2007-2011, was selected to take into account examination timeframes and appeals processes both before and during the financial crisis. Figures 1 through 6 cover average onsite days, average report processing days, and average total days combining both onsite and report processing times. RMS and DCP officials do not routinely track the average days for pre-examination planning, but RMS officials informed us that this phase of the examination typically takes 1-2 weeks.

[9] Turnaround time is defined by RMS as the number of calendar days from the start of a process until the end of that process. For example, onsite turnaround time measures the number of calendar days from the day the examination team starts onsite work at the institution's offices until the day the team completes its onsite work.

Risk Management Examinations. As shown in Figure 1, the average length of time onsite for risk management examinations varied from 20 to 33 days for institutions rated 1 or 2 in 2007-2011 and from 42 to 66 days for institutions rated 3, 4, or 5. The most notable trends are that the number of onsite days increased 20-27 percent for 1- or 2-rated institutions, from their low in 2007 to their high in 2011, but onsite days decreased 12-16 percent for 4- or 5-rated institutions from their high in 2008 to their low in 2011.

Figure 1: Risk Management Examinations – Average Onsite Turnaround Days for Institutions under $1 Billion in Assets, 2007-2011



Source: RMS Business Analysis and Decision Support Section.

Regarding the trend in 1- and 2-rated institutions, RMS officials indicated that, beginning in 2007, there was a change in examination procedures that increased the baseline procedures and allowed for more examiner discretion in expanding the scope of examinations, depending on what examiners found onsite. Also, as RMS hired more examination staff, there was more capacity to review areas of potential weakness in well-rated banks, as well as new staff to train.

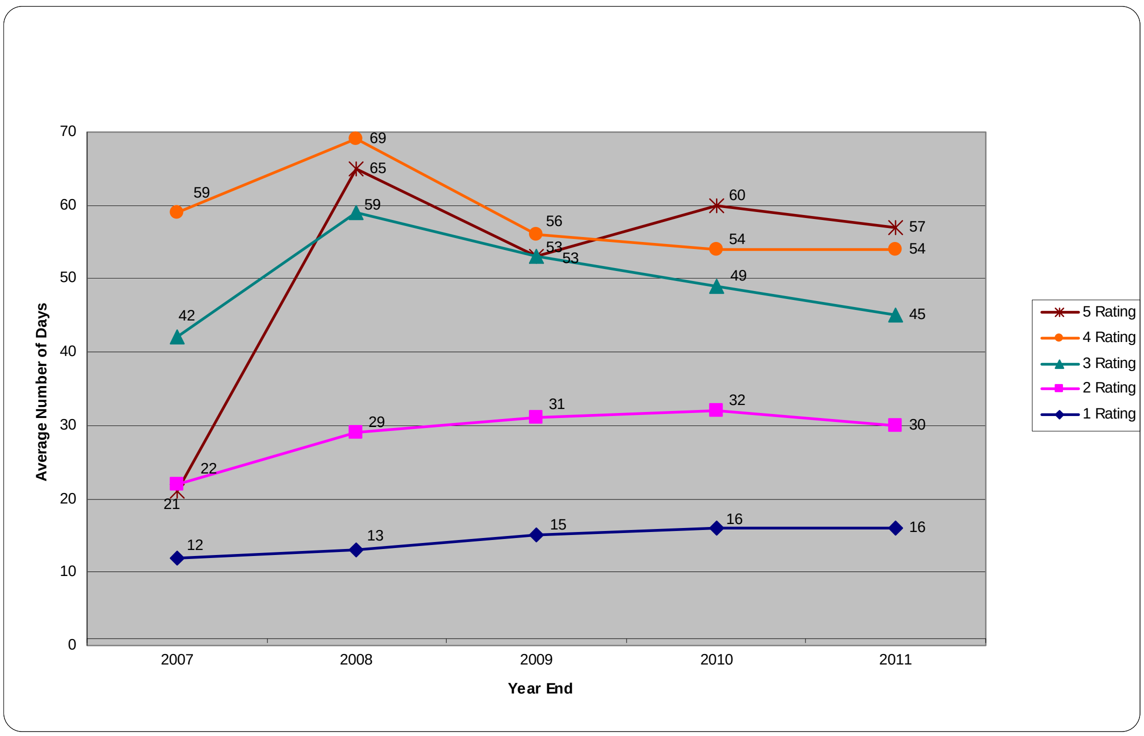
With respect to the trend in 4- and 5-rated institutions, RMS officials indicated that examinations with initial downgrades to problem institution status typically took more time than subsequent examinations, where problems had already been identified. The majority of problem institutions were initially downgraded between 2008 and early 2010, so RMS officials were not surprised that examination days trended downward in these institutions.

Figure 2 shows that average report turnaround days varied widely in the beginning years of the recent financial crisis, rising significantly from 2007 to 2008 for banks rated 2, 3, 4, or 5, but began to stabilize or decrease in 2009-2011. In addition, the turnaround time for that phase of the examination process generally ranged from:

- 2 to 4 weeks for institutions rated 1 or 2; and
- 6 to 9 weeks for institutions rated 3, 4, or 5.

The difference in processing timeframes between well-rated and troubled institutions can generally be attributed to the additional complexity and volume of deficiencies associated with the troubled institutions, the level of review required to ensure the reports fully supported lower ratings and appropriate supervisory actions, and examiners working with bank management and other regulatory agencies to reach agreement on the examination findings and supervisory actions before the final report was issued.

Figure 2: Risk Management Examinations – Average Report Turnaround Days for Institutions under $1 Billion in Assets, 2007-2011

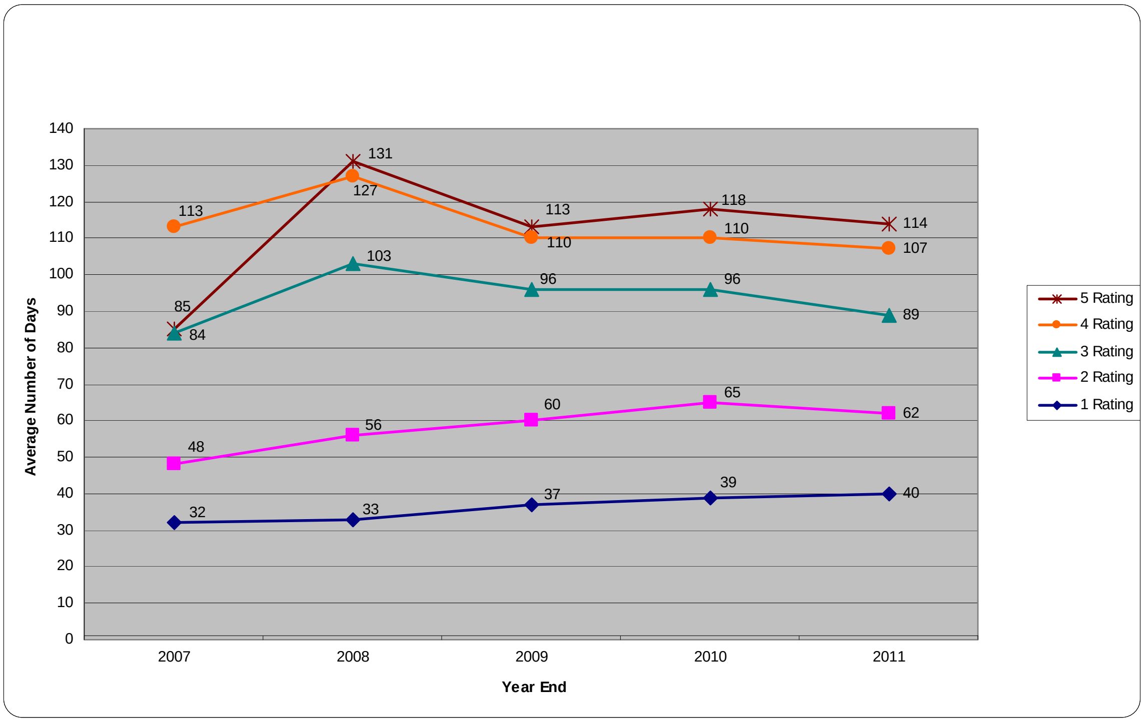


Source: RMS Business Analysis and Decision Support Section.

According to RMS officials, the trends in Figure 2 reflect the precipitous decline in the industry beginning in 2007 and 2008, when problems were first identified and initial downgrades were made. Processing times began to stabilize as additional report reviewers were added in the regional offices and both examiners and review staff became accustomed to addressing the common problems they were seeing.

As reflected in Figure 3, the total turnaround days for risk management examinations, combining both onsite and report processing times, show significant increases from 2007 to 2008 for banks rated 2, 3, 4, or 5, reflecting the increase in report processing times and then stabilization over the years 2009-2011.

Figure 3: Risk Management Examinations – Average Total Turnaround Days for Institutions under $1 Billion in Assets, 2007-2011



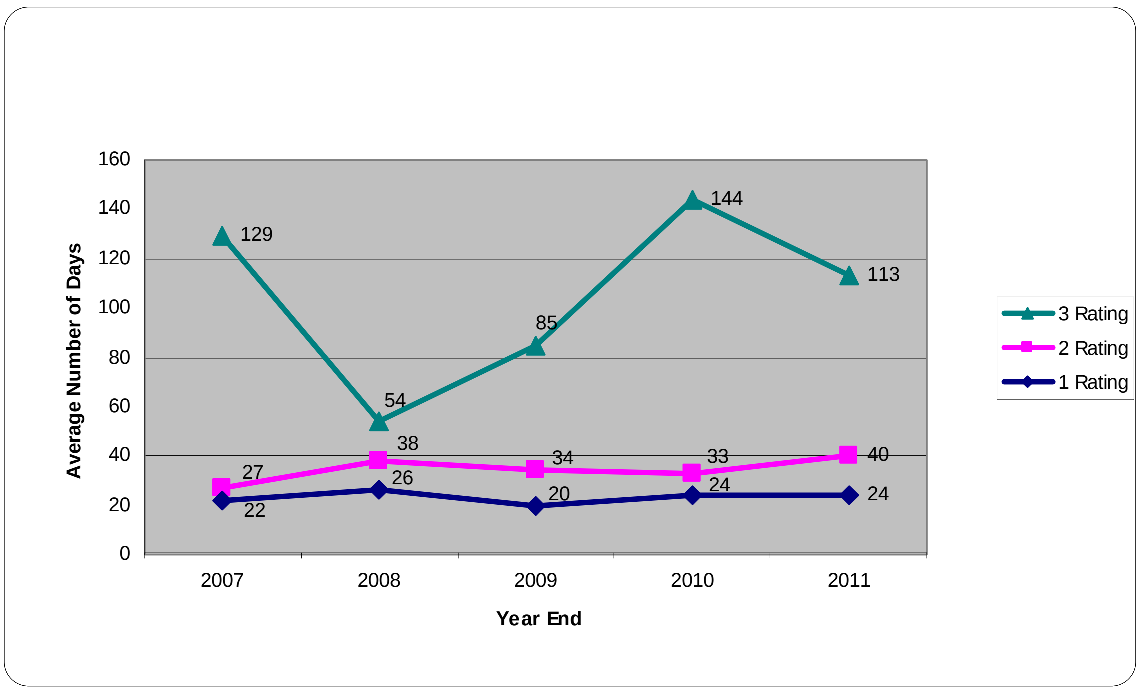
Source: RMS Business Analysis and Decision Support Section.

As noted for the previous figures, RMS officials explained that the overall trends observed were caused by the combination of changes in examination procedures in 2007, the decline in ratings beginning in 2007, the significant addition of examination and review staff to address the additional workload, and the subsequent stabilization of the industry.

Compliance Examinations. For purposes of presenting meaningful information pertaining to the timeframes for compliance examinations, we excluded timeframes for CRA performance evaluations (which are rarely conducted as stand-alone assignments) and instances where compliance examinations and CRA performance evaluations were conducted together. In addition, we found that the statistics for compliance examinations reflected few, if any, institutions rated 4 or 5 during 2007-2011.[10] This caused the turnaround days associated with those ratings to vary widely and did not provide sufficient information for comparison and analysis purposes. As a result, we omitted this data from our analysis.[11]

Figure 4 shows wide variability in the average onsite turnaround days for institutions with a compliance rating of 3, which we attribute to the low level of institutions receiving that rating. Generally, we identified a trend similar to what we found with risk management examinations—longer overall cycle times for these lower-rated institutions. The average onsite turnaround days for institutions rated 1 or 2 also show some variability, but no significant trends.

Figure 4: Compliance Examinations – Average Onsite Turnaround Days for Institutions under $1 Billion in Assets, 2007-2011



Source: RMS Business Analysis and Decision Support Section.

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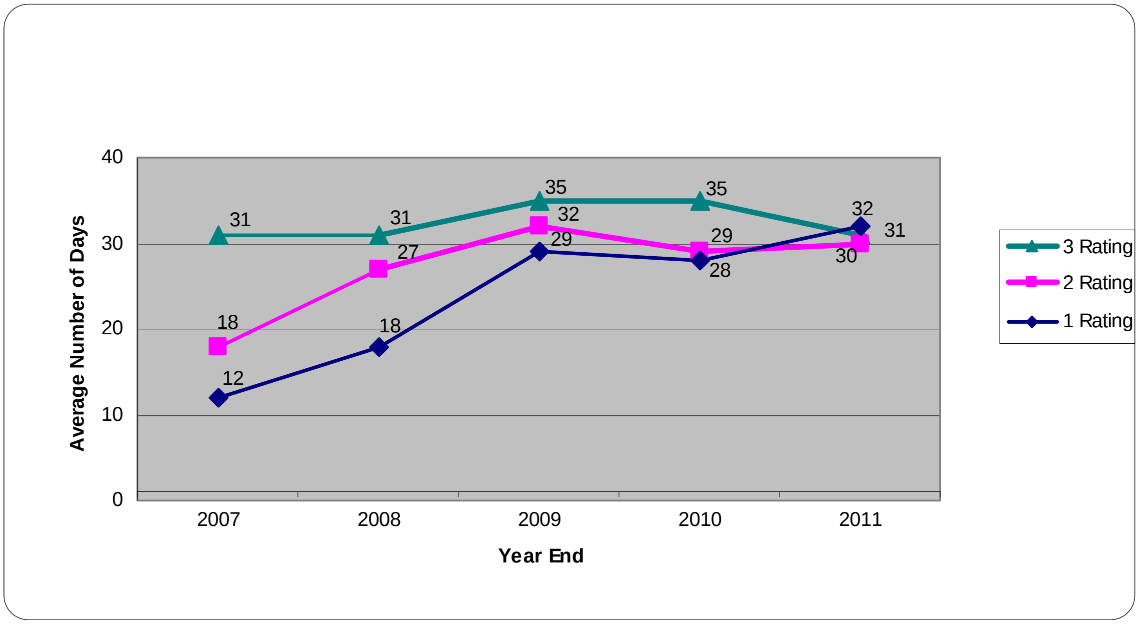
[10] Similar to risk management examinations, compliance examinations also provide a rating from 1 to 5, with 1 indicating a strong compliance position and 5 indicating an institution in need of the strongest supervisory attention.

[11] The number of institutions that received a compliance rating of 3 was also low, ranging from 19 to 73 institutions in any particular year, but we decided to include the data for 3-rated institutions in Figures 4, 5, and 6 because the information showed a steady trend for the average report turnaround days in Figure 5.

Another trend that we identified in the timeframe data for compliance examinations was that average report processing times increased significantly from 2007 to 2011 for institutions rated 1 or 2. Specifically, as shown in Figure 5, the average report turnaround days increased from 12 days to 32 days for 1-rated institutions and from 18 days to 30 days for 2-rated institutions. There was little variation in the average report turnaround days for 3-rated institutions.

Figure 5: Compliance Examinations – Average Report Turnaround Days for Institutions under $1 Billion in Assets, 2007-2011



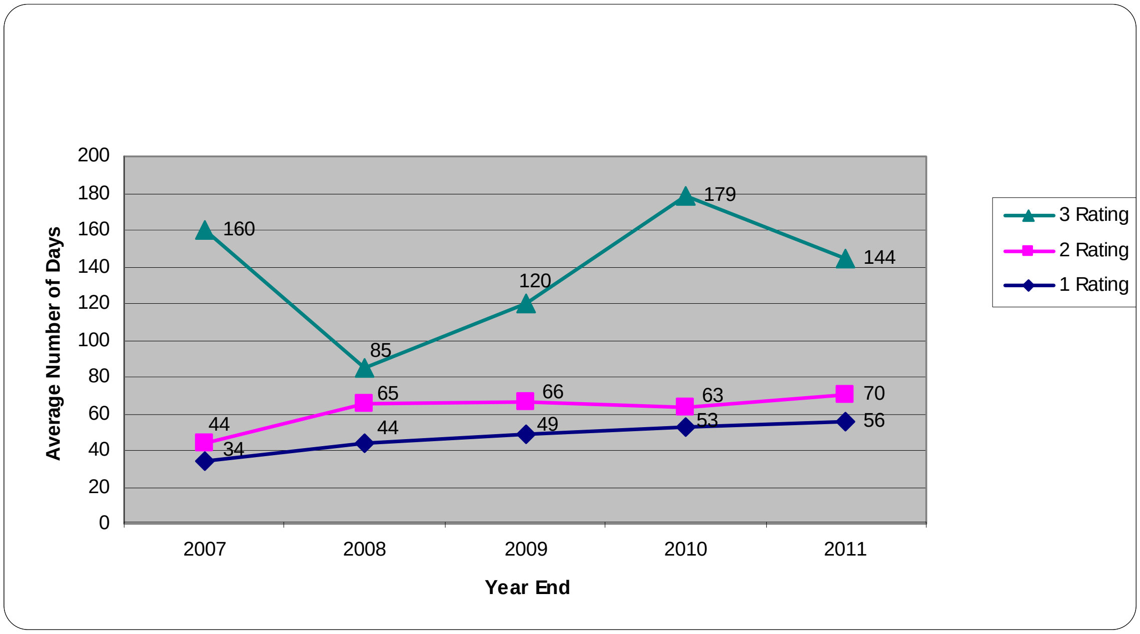
Source: RMS Business Analysis and Decision Support Section.

According to DCP management, the increase in the turnaround times was the result of several changes in DCP's examination process and staffing. Starting in 2008, DCP introduced several new examination processes as a result of regulatory changes. These changes included guidance related to third-party oversight, pre-exam planning procedures, and changes to consumer protection laws and regulations. In addition, DCP changed its consultation process in response to increased changes in financial products, often offered by third-parties, which required additional review of complex issues.

Increases in compliance examination staff over the past several years also required increased training and development. Field supervisors are delegated authority to process 1- and 2-rated reports without significant issues but, as a result of the increased need for training and development of staff, many of the 1- and 2-rated reports were reviewed by DCP review examiners, extending the review timeframes. DCP officials noted that although the turnaround time had increased, it was still within established timeframes.

Figure 6 shows the average total turnaround times for compliance examinations, combining both the average onsite and report turnaround days.

Figure 6: Compliance Examinations – Average Total Turnaround Days for Institutions under $1 Billion in Assets, 2007-2011



Source: RMS Business Analysis and Decision Support Section.

We identified FDIC timeframe goals for compliance/CRA examinations in 2010 and 2011, as follows:

- **2010:** Issue final examination reports for at least 90 percent of favorably-rated institutions within 90 days of the start of the examination for compliance-only examinations and within 120 days of the start of the examination for joint compliance/CRA examinations.

- **2011:** Issue final examination reports for at least 90 percent of favorably-rated institutions within 90 days of the start of onsite compliance-only or CRA-only examinations and within 120 days of the start of joint onsite compliance/CRA examinations.

- **2011:** Issue final examination reports for at least 90 percent of unfavorably-rated institutions within 150 days of the start of onsite compliance-only or CRA-only examinations and within 180 days of the start of joint onsite compliance/CRA examinations.

According to the FDIC's Annual Plans, the Corporation successfully met these performance targets. Additionally, DCP officials indicated that they continue to measure examination performance in 2012.

Control Processes for Examination Consistency

To address consistency in the administration of risk management and compliance/CRA examinations across the country, the FDIC has a framework of controls in place that are designed to consider the unique circumstances of each institution and the community in which it operates, as well as to ensure that institutions in similar conditions are treated in the same manner. The FDIC's control framework includes examination standards and guidance and examiner training. In addition, the FDIC ensures that appropriate supervision is provided in a consistent manner using a multi-layered supervisory process that involves:

- all levels of RMS supervision[12] (field offices, regional offices, and headquarters) to review examination results, examiner conclusions, and the resulting examination reports and, when deemed appropriate, to consider the applicability of informal supervisory or formal enforcement actions; and

- ongoing interaction and coordination with financial institutions' management and BODs.

The FDIC's control framework also includes efforts to monitor bank performance and responses to examination results and internal review and quality assurance processes to further promote consistency in its examinations and supervision. Further, the FDIC coordinates with a number of external councils and working groups on the federal and state levels to assure that its examination and supervision of community banks are consistent with other financial regulatory agencies.

Examination Standards and Guidance

The FDIC promotes safe and sound financial institution practices through a number of means, including conducting regular risk management examinations. Further, when appropriate, the FDIC has a range of informal and formal corrective actions available to resolve supervisory concerns identified during risk management examinations. The following sections discuss laws, rules and regulations, policies, and practices that promote and help ensure consistent treatment of institutions in similar conditions.

Specific Examination Standards Established by the FDI Act and Rules and Regulations. In addition to Section 10(b) of the FDI Act, which governs the FDIC's specific examination authority, the FDI Act also provides additional authorities, such as those related to investigations and Prompt Corrective Actions (PCA) that govern the FDIC's examination, supervision, and enforcement processes. Further, the FDIC Rules and Regulations provide guidance for examinations conducted by FDIC examiners. Such guidance relates, but is not limited, to BSA compliance, restrictions related to brokered

[12] The FDIC's internal control framework relates to both risk management and compliance/CRA examinations. Appendix 2 provides information regarding both types of FDIC examination processes. As indicated in Appendix 2, the compliance/CRA processes are similar to those used for risk management examinations.

deposits, and safety and soundness standards. Appendix 3 provides examples of the laws and rules and regulations applicable to the FDIC's examination and supervision processes.

Examination Guidance. As referenced earlier in the report, federal and state regulatory agencies, including the FDIC, use a standard system known as the Uniform Financial Institutions Rating System (UFIRS) to rate financial institutions. The UFIRS was adopted by the FFIEC on November 13, 1979. UFIRS is commonly referred to as the CAMELS rating system. Various changes in the banking industry and regulatory policies prompted a revision of the rating system in December 1996. The revisions to UFIRS include the addition of a sixth component addressing sensitivity to market risk, the explicit reference to the quality of risk management processes in the management component, and the identification of risk elements within the composite and component rating descriptions.

The UFIRS takes into consideration 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 in a comprehensive and uniform manner, and that supervisory attention is appropriately focused on institutions exhibiting financial and operational weaknesses or adverse trends. Over the years, the UFIRS has proved to be an effective supervisory tool for evaluating financial institutions on a uniform basis and for identifying institutions requiring special attention.

In addition, examiners use the Uniform Interagency Consumer Compliance Rating System to rate financial institutions during compliance/CRA examinations. As with the UFIRS, each bank is assigned a consumer compliance rating based on a scale of 1 through 5 in increasing order of supervisory concern.

Further, the FDIC provides guidance to its examination staff and supervised financial institutions primarily by issuing Regional Directors (RD) Memoranda, Financial Institution Letters (FIL), examination manuals, and other forms of guidance, such as Examination Documentation (ED) Modules. Such guidance promotes consistency in the examination process. The guidance covers a variety of topics, informs financial institutions of supervisory expectations, and, generally, communicates the FDIC's expectations and authorities. Appendix 4 provides additional information regarding the policy and examination guidance the FDIC provides to its examination staff and financial institutions.

Examiner Training Activities

The FDIC provides training to both risk management and compliance examination staff through various means. To ensure that its examination staff is aware of the Corporation's expectations, training requirements, required commissions, and benchmarks, the FDIC has issued substantial guidance that outlines such training and that contributes to consistency in the training and examination processes. The FDIC's training activities are used to reinforce and provide practical experience regarding the FDIC's standards established in applicable guidance; laws and rules and regulations; and supervisory position, expectations, and authorities. FDIC risk management and compliance examiners must satisfactorily complete a required course curriculum and a program of on-the-job training (OJT) before they can become commissioned examiners. The FDIC also supports its examination staff in the pursuit of professional certifications, such as those related to BSA and anti-money laundering (AML), public accounting, fraud, financial analysis, information systems, and bank auditing. Appendix 5 provides additional information regarding the FDIC's examiner training activities, including the role of the FDIC's Corporate University. As discussed later in this report, the FFIEC also provides training for the FDIC and the other regulatory agencies.

Supervisory Review Process

The FDIC's organizational structure includes six regional offices and two area offices. Each of the area offices reports to and is part of a regional office. The regional and area offices are each responsible for a number of field offices. As a result of this widely-distributed workforce, the Corporation faces a constant challenge in maintaining a consistent approach to common issues and risks. In that regard, the FDIC uses a multi-level examination process to conduct, supervise, and review examinations that includes:

- offsite pre-examination planning and analysis;
- risk-scoping activities to focus resources on a bank's highest risk areas;
- onsite execution of the examination; and
- ongoing communication with the financial institution management and BODs before, during, and after the examination.

The FDIC's multi-level supervisory review process includes examiners-in-charge (EIC) and supervisors in the field or regional offices and is in place to assure consistency in its supervision and examination processes. Before being issued in final form, the examination report undergoes a quality control review by the responsible field or regional office to ensure the content is accurate, the findings are consistent with FDIC policies, and the tone is appropriate given the institution's overall condition. In certain cases, such as when formal enforcement actions are involved, financial institutions are rated 4 or 5 (or in some cases 3), or other significant examiner concerns are identified, the review and approval process will also involve RMS headquarters. According to FDIC officials, this process helps to ensure that agency guidance and the supervisory treatment of financial conditions are applied in a consistent manner.

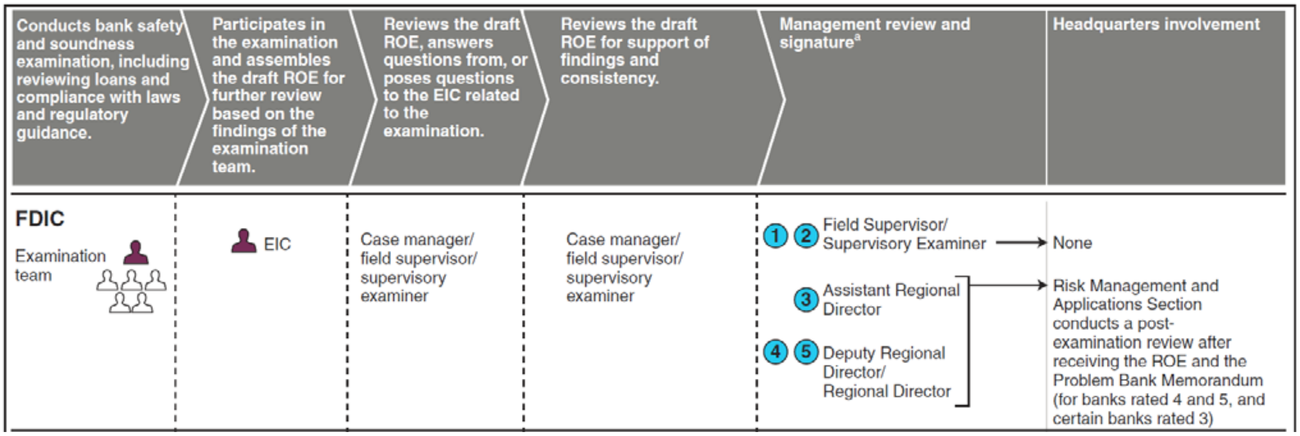
Regional office involvement in the supervisory approach to financial institutions is significant to the FDIC's overall supervisory process. For example, regional office case managers, in conjunction with regional office senior management, coordinate and direct the RMS supervisory program using a top-down approach to develop strategies and examination activities for all insured depository institutions.[13] The primary responsibilities of case managers include assessing risk to the Deposit Insurance Fund (DIF) and implementing the appropriate supervisory approach to eliminate or manage

[13] According to DCP officials, their review process is very similar, with DCP review examiners performing the same responsibilities as RMS case managers.

such risk. To properly assess risk, case managers must maintain an informed position on the financial institutions for which they are responsible. To achieve that goal, case managers review examination reports and correspondence, review press releases and other media sources, consider offsite monitoring results, and communicate with other regulatory agencies and financial institution officials.

Regional office involvement in the review is not limited to case managers. As indicated below in Figure 7, the FDIC's risk management examination review process also involves senior regional office management and, in some cases, RMS headquarters.

Figure 7: Overview of the Risk Management Examination Review Process



Source: Government Accountability Office (GAO) -11-489, *Enhanced Guidance on Commercial Real Estate Risks Needed*, May 19, 2011.

* The numbers in the circles are composite CAMELS ratings.

Notes: ROE is an acronym for Report of Examination.

A problem bank memorandum documents the FDIC's concerns with an institution and the corrective action in place or to be implemented. A problem financial institution is defined as any insured institution that has been assigned a composite rating of 4 or 5,or 3 for certain financial institutions, by its primary federal regulator or by the FDIC.

In addition, the review process may include consultation with the FDIC's Legal Division. Generally, the mission of the Legal Division is to provide the FDIC with timely, comprehensive, and cost-effective legal services that support the Corporation's oversight of the safe and sound operation of insured depository institutions; compliance with applicable civil and criminal laws and regulations, including appropriate measures in response to violations; and its responsibilities related, but not limited, to the resolution of financially troubled and insolvent institutions.[14]

For example, the Legal Division's Enforcement Section works closely with bank and review examiners to ensure bank compliance with banking and consumer protection laws and regulations, and to ensure the continued safety and soundness of insured depository institutions. In addition, where unsafe or unsound practices, violations of law, or unsafe or unsound conditions are discovered, usually as a result of the examination of a financial institution or a consumer complaint, appropriate action is taken to ensure correction. The

[14] DCP officials indicated that the Legal Division provides support to DCP regarding significant consumer protection violations and needed enforcement actions.

Enforcement Section reviews enforcement cases provided by the regional offices to ensure compliance with FDIC policies and substantive case law. Further, the Enforcement Section also works with the regional offices and other bank regulatory agencies to promote consistent enforcement policies and procedures. In particular, the Legal Division provides assistance when (1) there is a need to determine whether there are apparent violations of laws and regulations and (2) examiners recommend imposing a formal enforcement action based on examination results.

Further, the FDIC's Chief Accountant contributes to consistency in the examination and supervision processes by participating in the development of the FDIC's regulations and supervisory policies; reviewing institutions' accounting for specific transactions, when called upon to do so; and ensuring the appropriate and consistent application of supervisory and examination criteria related to significant economic and accounting issues.

Supervisory Actions

Problems or concerns that may justify the need for the FDIC to consider or impose a supervisory or enforcement action against a bank or a bank official or director may come to the FDIC's attention in a number of ways. The majority of the actions result from examinations. The remaining actions result from bank employees or customers who volunteer information concerning irregular activities in banks. Such disclosures could, in turn, lead to FDIC visitations or an investigation. Financial information that may justify enforcement action may also be obtained from the reports of condition and income filed by banks on a quarterly basis.

The FDIC's *Risk Management Manual of Examination Policies* (Examination Manual) requires examiners to document their findings through a combination of brief summaries, source documents, report comments, and other workpapers that describe examination results, including the bank's financial condition , its management practices, and examination conclusions. Although examination documentation may be maintained in various ways, examiners must securely retain appropriate supporting records of all major examination conclusions, recommendations, and assertions detailed in the examination report. Based on the examination results, examiners recommend appropriate corrective action, if any, to their field and regional office officials. Especially in a bank deemed to be a "problem bank," or in unusual situations, examination reports are discussed with the field office supervisor during the examination. Conversely, when an examiner identifies problems of a relatively inconsequential nature, such as those not impacting the soundness of the institution, the examiner will make the bank aware of the problem and work with bank management towards a resolution. If the examiner has confidence that the bank can and will rectify the problem, no further action may be required at that time.

If it becomes clear that informal cooperation will not be effective or identified problems are serious, the FDIC has a wide range of both informal supervisory and formal enforcement actions that it may use. The supervisory and enforcement options available to the FDIC, from the least to the most severe, are as follows:

- moral suasion and other informal means;
- examination of institutions;
- written agreements, bank board resolutions (BBR), memoranda of understanding (MOU), and formal agreements;
- cease and desist/consent orders and PCA directives against institutions, officials, or other participants;
- removal proceedings against officers, directors, or other participants;
- prohibition orders against officers, directors, or other participants;
- civil money penalties (CMP) imposed against institutions and their officials; and
- termination of deposit insurance.

Actions taken by the FDIC to address consistency in the consideration and imposition of supervisory actions involve the use of specific guidance and the examination team's and field office's coordination with regional officials, the Legal Division, and FDIC headquarters.

The FDIC has issued specific guidance in the *Formal and Informal Action Procedures Manual* (FIAP Manual) and RD memoranda to inform its examination staff as to when and what type of informal or formal supervisory actions should be considered as a result of an examination. In addition to complying with stated guidance, before imposing informal or formal actions against financial institutions, examiners consult with and discuss examination results and their concerns regarding financial institution operations, compliance with laws and regulations, and contraventions of policy with examination team members and their respective field and regional office supervisors. Jointly, the examination team and regional and field office management decide whether supervisory action is warranted, and if so, what type of action is appropriate.

Each level of FDIC supervision has certain delegated authorities. However, decisions regarding the appropriate FDIC supervisory strategy for community banks are made in a collaborative manner with all levels of FDIC supervision available for review and consultation. More specifically, examiners, case managers, and FDIC regional office supervisors consult and coordinate with regional office Legal Division representatives and, if necessary, RMS headquarters officials regarding whether and what type of supervisory actions should be imposed against FDIC-supervised financial institutions.

After the regional office has completed its review, certain enforcement actions, such as prohibition and removal stipulations and notices, are forwarded under the Regional Director's signature (with concurrence by the Legal Division's Regional Counsel) to the appropriate RMS headquarters officials for review and approval. RMS headquarters officials also review problem bank examination reports and memoranda submitted by the regional offices and, if necessary, consent or cease and desist orders, as well as supervisory strategies for certain FDIC-insured and/or supervised financial institutions.

Quality Assurance Reviews and Other Tools for Monitoring Examination Processes

The RMS Internal Control and Review Section (ICRS) helps to ensure consistency in the Corporation's examination and supervision processes. RMS established ICRS to facilitate the review of the activities and the overall operational efficiency and effectiveness of RMS. More specifically, ICRS:

- supports and enhances RMS's ability to identify and mitigate risk by developing, implementing, overseeing, and coordinating internal review, audit liaison, internal control, and risk management programs;

- helps to ensure that RMS identifies, mitigates, and manages high-risk banking practices, evolving risks, challenges, and operating risks using sound internal control procedures;

- performs internal reviews, including regional office reviews; and

- provides expertise in internal control and risk management matters.

DCP, established in 2011, also has an internal control and review function (ICR). The DCP Operations and Technical Systems Section's ICR has processes, comparable to ICRS, to promote consistency in the compliance examination process. In addition to performing internal reviews and providing expertise in internal control and risk management matters, ICR provides DCP senior management with a performance overview of the regions' systems, controls, and decision-making processes, including feedback of the overall operations.

ICRS and ICR conduct concurrent but separate reviews of their six regional offices on a triennial cycle. The objectives of these regional reviews are to assess management's systems, controls, decision-making processes, and supervisory strategies and to report findings to senior RMS management. The general scope of the reviews includes, but is not limited to:

- Performing limited risk-focused reviews of the regions' supervisory actions and responses over time, including detailed reviews of risk management and compliance examination reports and CRA performance evaluations, institution applications, and supervisory strategies for a sample of institutions.

- Ensuring that the FDIC uses a consistent approach, across all regions, in examination procedures, ratings, and corrective actions required when examining banks for compliance with consumer protection regulations.

- Determining the regions' timeliness and effectiveness of supervisory actions and communications and ensuring that the regional offices effectively monitor the compliance of FDIC-supervised institutions with informal and formal actions.

- Performing risk-focused reviews of targeted areas, such as PCA, asset and/or liability concentrations, compliance with outstanding guidance, management's communications, and implementation of new or revised guidance and programs.

- Following up on the status of recommendations made during prior regional reviews and other reviews/audits conducted by external and/or internal entities.

- Ensuring the region implements strategies to mitigate issues identified during self-assessments and challenges identified in the Regional Director's Annual Assurance Statements.[15]

Table 5 shows which regional offices were reviewed during 2007–2011.

Table 5: Regional Reviews, 2007-2011*

Regional Office	2007	2008	2009	2010	2011
Atlanta	√				√
Chicago		√			
Dallas			√		
Kansas City	√				√
New York		√			
San Francisco	√			√	

Source: FDIC ICRS.
* According to ICRS and ICR officials, the number of regional reviews conducted may vary depending on available resources.

Monitoring of Informal and Formal Actions. The FDIC has a number of automated systems that are used to record, track, and monitor supervisory actions. Those systems include ViSION, the System of Uniform Reporting of Compliance and Community Reinvestment Act Examinations (SOURCE), and the Formal and Informal Action Tracking system. These systems are accessible to FDIC staff in the field, regional, and headquarters offices and can be used to generate routine and customized reports related to actions imposed by the FDIC and actions taken by financial institutions in response to those actions. The systems facilitate information-sharing among examination staff and management regarding how issues are handled from region to region and, by extension, assist in the consistent treatment of institution risks and circumstances.

In addition, each region has an information group (Regional Office Information Management Group) that collects data and prepares reports, including PCA reports and watch lists for compliance and CRA, for management oversight of the examination function. These reports are also available to headquarters for cross-region monitoring.

[15] Annually, each region will satisfy an accountability requirement by submitting a written report that provides reasonable assurance that the region's system of internal controls is effective.

Coordination with External Councils and Working Groups

The FDIC coordinates with a number of external Councils and working groups that include the other financial regulatory agencies. Participation with these groups further promotes consistency in the Corporation's examination and supervision of community banks.

Membership and Participation in FFIEC Activities. As stated previously, the FDIC is a member of the FFIEC, which prescribes uniform principles, standards, and report forms for the examination of financial institutions by federal and state regulatory agencies. The FFIEC publishes handbooks, catalogs, and databases that provide uniform guidance and information to promote a consistent examination process among the agencies. In addition, as part of its mandate, the FFIEC provides training for federal and state examiners. The goals of the training program are to (1) promote training efficiency by encouraging consistency of examiner education through joint sponsorship of interagency training; (2) develop, maintain, and deliver timely, cost-effective, and state-of-the-art interagency training; (3) serve as a central point for training opportunities offered by the member agencies; and (4) support the initiatives of the FFIEC and its task forces. The FFIEC provides training in such areas as community financial institution lending, asset management, commercial real estate, real estate appraisals, financial crimes, and BSA/AML.

To further enhance examination consistency among the FFIEC members, including the FDIC, the FFIEC has a number of task forces that assist in achieving its mission. More specifically, there are six task forces to effectively administer the full spectrum of projects in the FFIEC's functional areas, including, but not limited to, researching future enhancements for examiner guidance, examiner training, and reporting. Each task force is composed of six senior officials from the five federal regulatory agencies and a representative of the SLC. There is a separate task force for each of the following subject matters:

- examiner education,
- supervision,
- reports,
- information sharing,
- surveillance systems, and
- consumer compliance.

Appendix 6 provides additional information regarding the FFIEC task forces.

Coordination and Membership in Other Task Forces and Working Groups. In addition to the FFIEC, the FDIC coordinates with other agencies to promote consistency in its supervision and examination processes. For example:

- The FDIC works with the FRB, OCC, and NCUA to address issues and programs that transcend the jurisdiction of each agency, such as the development of regulations.

- The FDIC also works with several inter-agency groups, such as the BSA Advisory Group, the FFIEC BSA/AML Working Group, the National Bank Fraud Working Group, and the Terrorist Finance Working Group, to help combat issues and concerns related to compliance with the BSA, USA PATRIOT Act, and anti-fraud and terrorist finance groups.

Coordination with CSBS and the State Regulatory Agencies. The FDIC works closely with state banking departments, as well as the CSBS, to promote efficiency and uniformity in the bank examination process. The FDIC has cooperative agreements with most states to conduct joint or alternating risk management examinations. If a state supervisor responsible for an examination has scheduling, staffing, or other resource constraints that may negatively impact the statutory examination frequency requirement for a financial institution, the FDIC will work with the state supervisor to make sure that any delinquent examination is scheduled and completed. When appropriate, the FDIC may conduct the examination instead of the state supervisor.

Under the FDI Act, the FFIEC is responsible for issuing guidelines and establishing standards for determining the adequacy of state examinations. The FFIEC guidelines for relying on state examinations, issued in June 1995, stipulate that the federal banking agencies will "accept and rely on state examination reports in all cases in which it is determined that state examinations enable the federal banking agencies to effectively carry out their supervisory responsibilities." The FDIC's acceptance of a state examination report is based on the following criteria:

- The completeness of the state examination report.

- The adequacy of documentation maintained by state examiners to support observations made in examination reports.

- The ability over time of a state banking department to achieve examination objectives and the FDIC's consideration of the adequacy of state budgeting, examiner staffing and training, and the overall review and follow-up examination process of a state banking department.

- Accreditation[16] of a state banking department by the CSBS.

- The adequacy of any formal or informal arrangement or working agreement between a state banking department and the FDIC.

[16] The CSBS Accreditation Program involves a comprehensive review of the critical elements that assure the ability of a state banking department to discharge its responsibilities through an investigation of its administration and finances, personnel policies and practices, training programs, examination policies and practices, supervisory procedures, and statutory powers.

Protocols for Questioning FDIC Examination Results

According to the FDIC, financial institutions should expect examination findings to be fair, fact-based, and consistent with FDIC policies and procedures. Nevertheless, institutions have multiple avenues available to question examination results when agreement between examiners and bankers cannot be reached. These avenues include informal channels for raising examination-related concerns directly with RMS and DCP officials and formal channels for requesting division-level review by RMS, DCP, or OCFI and for appealing material supervisory determinations to the SARC. Additionally, an ALJ is available to conduct hearings related to formal enforcement actions. Bankers may also contact the FDIC's Central Call Center, OO, or other offices, as discussed later in this report.

Based on our review of the formal processes, the frequency of division-level reviews and SARC appeals by FDIC-supervised institutions is low, and it is rare that these reviews and appeals result in overturning a material supervisory determination. Additionally, we noted that two-thirds of the reviews and appeals submitted during 2007-2011 exceeded self-imposed FDIC timeframes.

The FDIC informed institutions of the various channels available for resolving examination concerns in FIL-13-2011, *Reminder on FDIC Examination Findings*, issued in March 2011, as follows:

> The FDIC encourages financial institutions to provide feedback on FDIC examinations, Reports of Examination, and other supervisory processes. An open dialog with bank management is critical to ensuring the supervisory process is effective in promoting an institution's strong financial condition and safe-and-sound operation. If an institution disagrees with examination findings, it should address those concerns through communication with the examiner, field office management, or the appropriate regional office staff. Division-level informal reviews are also available. If informal efforts to resolve disagreements are not successful, an institution may pursue a formal supervisory appeal.

Additionally, the FIL states:

> Institutions with concerns about examination findings, assigned ratings, or other supervisory determinations reached by the FDIC often find that the most effective method for understanding the FDIC's conclusions is to discuss the matter with the EIC or contact the appropriate field or regional office. Banks can informally contact FDIC offices by telephone or email, or request a meeting in-person. Institutions also can express concerns as part of their examination response letter or other correspondence. If an institution is unable to resolve its concerns with the regional office or believes that its regional office is not carrying out FDIC policies in the manner intended by the Chairman or Division management, it is encouraged to contact the appropriate Division Director for an informal review.

The FIL provides contact information for the RMS and DCP Division Directors, as well as contact information for the FDIC's OO and the six regional office ombudsmen. According to RMS regional office management, institutions frequently communicate with examiners and field and regional office officials, resulting in a constructive and robust examination and supervisory process.

Informal Protocols

Informal discussions generally take place prior to the issuance of a final examination report but may occur at any time. These discussions may involve various levels and processes within RMS[17] and include members of the examination team, field office staff, regional office staff, and a Post-Examination Survey.

FDIC examiners engage in ongoing dialogue with bank officials during examinations to discuss preliminary findings and provide management with an opportunity to respond, so that all perspectives are appropriately considered. At the bank's discretion, concerns about examination findings can be raised to the field office supervisor or the regional office, including the regional directors and deputy regional directors, as these individuals are actively involved in working with institutions as significant matters arise.

The sections below provide an overview of the opportunities available for bankers to raise concerns and facilitate dialogue on potential disagreements during and outside of the examination process.

Before and During the Onsite Examination

The Examination Manual identifies ongoing communication between the examination staff and bank management as a critical element of effective bank supervision. During pre-examination planning, the FDIC notifies bank management of the examination start date for onsite fieldwork and sends an information request to obtain data on the bank's loan portfolio and other activities. The EIC also schedules a pre-examination contact with bank management to identify economic conditions impacting the bank's financial condition, operational and functional changes, and what senior bank management considers to be the highest risk areas.

Informal meetings are held as needed throughout the examination to discuss various topics and to gain management's perspective on local economic conditions and bank-specific issues. The Examination Manual indicates that all major examination issues should be discussed with senior management as soon as practical during an examination. The Examination Manual also instructs examiners to encourage the institution's board members to attend any or all meetings conducted during the examination to improve

[17] Since the functions of RMS and DCP were combined in one division until February 2011, we confirmed with DCP management that its compliance/CRA examination processes were consistent with the processes followed by RMS. At the regional and field office levels, both RMS and DCP staff continue to report to the same regional directors.

communication with board members and increase their knowledge of the examination process.

Exit Meeting with Management

The last step of the onsite phase of the examination is an exit meeting with management. According to the Examination Manual, examiners should thoroughly discuss their findings and recommendations with senior bank management prior to the conclusion of the examination. Exit meetings should fully apprise bank management of all deficiencies and recommendations that will be cited in the examination report. Such meetings are critical in communicating examination findings to the bank and providing management an opportunity to respond.

Following the Onsite Examination

While RMS supervisory review of the draft examination report is in process, there may be further discussions with bank management or the bank's BOD, especially if the examination findings warrant some level of supervisory or enforcement action. During this time, bank management is welcome to discuss any continuing concerns with field and/or regional office management.

Meetings with Directors. Examination results are usually presented at a meeting of the bank's BOD or a BOD committee. According to the Examination Manual, the FDIC's policies for meetings with BODs are designed to encourage director involvement in, and enhance director awareness of, FDIC supervisory efforts and to increase the effectiveness of such efforts.

After issuance of the final examination report, each BOD member is expected to read the report in its entirety and sign a signature page in the report, acknowledging that they have personally reviewed the contents of the report. The BOD review should be recorded in the board minutes, and the signed report should be maintained in the bank's records. All report contents and ratings are confidential.

Post-Examination Survey. To assist RMS and DCP in improving the quality and efficiency of their examination processes, the FDIC asks each institution at the end of an examination to complete a Post-Examination Survey. This survey allows the bank to provide feedback on the examination process. The survey is Web-based, and an access code is provided with the final examination report. The individual results of the survey are confidential. The FDIC's DIR prepares a report providing the aggregated responses received each calendar quarter.

The survey covers five general areas:

- pre-examination process results and timeframes;
- examiners' communications, expertise, and responsiveness;
- examination process results and timeframes;
- examination report clarity, accuracy, and usefulness; and

- overall benefits and fairness of the examination.

In addition, an FDIC headquarters official will contact the banker if requested on the survey form. In 2011, 22 bankers requested a contact, but RMS and DCP officials indicated that no issues were raised of a material concern.

DIR's desired response rate for the Post-Examination Survey is 70 percent. However, for the period covered by our audit, the highest response rate was 45 percent for the third quarter of 2007 and the lowest response rate was 28 percent for the third quarter of 2010. Each RMS regional office receives the quarterly aggregate results and is expected to take action to address any issues that arise from the survey.

Formal Protocols for Appealing Material Supervisory Determinations

After issuance of the final examination report, institutions can pursue their concerns through the formal review and appeals processes. Section 309(a) of the Riegle Community Development and Regulatory Improvement Act of 1994 (Riegle Act) required the FDIC and the other federal banking agencies to:

- establish an independent intra-agency appellate process to review material supervisory determinations,

- ensure that an appeal of a material supervisory determination by an insured depository institution is heard and decided expeditiously, and

- ensure that appropriate safeguards exist for protecting appellants from retaliation by agency examiners.

The Riegle Act defines the term "independent appellate process" as a review by an agency official who does not directly or indirectly report to the agency official who made the material supervisory determination under review. The FDIC adopted its original Guidelines for Appeals of Material Supervisory Determinations[18] (Guidelines for Appeals) in 1995 to establish operational procedures for a division-level review process and an independent SARC appeals process.

Definition of Material Supervisory Determinations

The term "material supervisory determinations" was defined in the Riegle Act to include determinations relating to:

- examination ratings,
- the adequacy of loan loss reserve provisions, and

[18] For additional information regarding the FDIC's Guidelines for Appeals of Material Supervisory Determinations refer to http://www.fdic.gov/regulations/laws/sarc/. This link also includes information on SARC decisions.

- classifications on loans that are significant to an institution.

The Riegle Act specifically excluded from the definition any decisions to:

- appoint a conservator or receiver for an insured depository institution, or
- take PCA pursuant to section 38 of the FDI Act.

Finally, the Riegle Act expressly provided that the requirement to establish an appeals process should not affect the authority of the agencies to take enforcement or supervisory actions against an institution. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) had previously established a separate process for the legal review of administrative enforcement proceedings (see the section entitled, *Administrative Law Judge Process*, later in this report).

In March 1995, the FDIC's BOD adopted the Guidelines for Appeals. In addition to the statutory exclusions noted above, the Guidelines for Appeals excluded from the definition of material supervisory determinations:

- determinations for which other appeals procedures exist (such as determinations relating to deposit insurance assessment risk classifications),
- decisions to initiate formal enforcement actions under section 8 of the FDI Act,
- decisions to initiate informal corrective actions (such as BBRs or MOUs),
- determinations relating to a violation of a statute or regulation, and
- any other determinations not specified in the Riegle Act as being eligible for appeal.

The Guidelines for Appeals were modified in later years as follows:

- in 2004, to change the composition and procedures of the SARC;
- in 2008, to eliminate appeals of the determinations underlying enforcement actions;
- in 2010, to extend the deadlines for divisions to respond to requests for review and the time available to the SARC for reviewing and notifying the institution in writing of its decision; and
- in 2012, to reflect various legislative and organizational changes.

The FDIC distributed the revised Guidelines for Appeals to all FDIC-supervised financial institutions through FILs.

Requests for Review

Among other changes, the Guidelines for Appeals were revised in 2012 to reflect FDIC organizational changes that became effective in February 2011, recognizing that matters subject to appeal could pertain to RMS, DCP, or OCFI. FDIC-supervised institutions must request a review of material supervisory determinations through RMS, DCP, or OCFI before an appeal is made to the SARC.

Under the Guidelines for Appeals, an institution may file a request for review of a material supervisory determination with the division or office that made the determination within 60 calendar days following the institution's receipt of an examination report containing a material supervisory determination or other written communication of a material supervisory determination. Institutions are encouraged to attempt to resolve the dispute with the FDIC examiner or applicable regional/area office before filing a request for review with the appropriate director.

A request for review must be in writing and include:

- a detailed description of the issues in dispute,
- how resolution of the dispute would materially affect the institution,
- whether a good-faith effort was made to resolve the dispute with the onsite examiner and the regional office, and
- a statement that the institution's BOD has considered the merits of the request and has authorized that it be filed.

The Guidelines for Appeals call for the division or office director to issue a written determination on the request for review, setting forth the grounds for that determination, within 45 days of receipt of the request.[19] No appeal to the SARC is allowed unless an institution has first filed a timely request for review with the appropriate division or office director.

Frequency and Results of Requests for Review. For the 5-year period ended December 31, 2011, FDIC-supervised institutions submitted 41 requests for review of material supervisory determinations. Of that total, 23 requests were related to risk management examinations and 18 were related to compliance/CRA examinations. Table 6 shows the frequency of these requests from 2007 to 2011.

Table 6: Frequency and Types of Requests for Review, 2007-2011

Year	Risk Management	Compliance/CRA	Totals
2007	1	7	8
2008	4	3	7
2009	3	2	5
2010	7	4	11
2011	8	2	10
Totals	**23**	**18**	**41**

Source: RMS Risk Management Examinations Branch. RMS provided information on all division-level appeals submitted by FDIC-supervised institutions during 2007-2011, including any that would have been applicable to DCP or OCFI in 2011.

[19] In April 2010, the timeframe for the appropriate director to issue a decision following a filing of a request for review was extended from 30 days to 45 days. There are no specific timeframes established by law.

Of the 41 requests, 28 were completed as follows: 24 were denied, 3 risk management requests were partially sustained, and 1 compliance/CRA request was sustained. The remaining 13 requests were not completed for the following reasons:

- 8 requests were found to be not appealable under the Guidelines for Appeals,
- 4 requests were withdrawn by the institution, and
- 1 institution was closed.

According to FDIC officials, most requests are denied because the applicable division director usually finds that the material supervisory determinations were consistent with FDIC policy.

Additionally, regarding the timeframes for processing the 28 completed requests, 20 of these requests were processed under the original 30-day timeframe, and 8 of these requests were processed under the revised 45-day timeframe established in April 2010. Of the 20 requests processed under the original timeframe, 18 requests exceeded the timeframe, of which 12 exceeded the timeframe by up to 61 days and 6 exceeded the timeframe by 90 to 383 days. Of the 8 requests processed under the revised timeframe, 1 request exceeded the timeframe by 4 days.

Appeals to the Supervision Appeals Review Committee

Within the FDIC, the SARC provides the independent intra-agency appellate process for reviewing material supervisory determinations, as required by the Riegle Act. SARC membership consists of three voting members:

- one inside FDIC Board member, designated by the FDIC Chairperson, who serves as the Chairperson of the SARC; and

- one deputy or special assistant to each of the inside FDIC Board members who are not designated as the SARC Chairperson.

The FDIC General Counsel is a non-voting member of the SARC. If there are vacancies, the FDIC Chairperson may designate alternate members, provided that they were not involved in making or affirming the material supervisory determination under review.

An institution that does not agree with the written determination rendered by the division or office director must appeal that determination to the SARC within 30 calendar days from the date of that determination. An appeal may be dismissed by the SARC if it is not filed in a timely manner, if the basis for the appeal is not discernable from the appeal, or if the institution moves to withdraw the appeal.

From 2004 to 2010, the Guidelines for Appeals required the SARC to review an appeal and notify the institution in writing of its decision "within 60 days from the date the appeal is filed, or within 60 days from oral presentation, if held." In April 2010, the guidelines were changed to require that a SARC meeting be held within 90 days from the date of the filing of the appeal, and for the SARC to issue a written decision within 45 days from the date the SARC meets to consider the appeal.

Frequency and Results of SARC-Level Appeals. Of the 41 division-level requests for review of material supervisory determinations submitted by FDIC-supervised institutions during the 5-year period covered by this audit, 23 were further appealed to the SARC. Of these 23 SARC appeals, 9 were related to risk management examinations and 14 were related to compliance/CRA examinations. Table 7 shows the frequency and types of SARC appeals from 2007 to 2011.

Table 7: Frequency and Types of SARC-Level Appeals, 2007-2011

Year	Risk Management	Compliance/CRA	Totals
2007	1	4	5
2008	0	2	2
2009	2	3	5
2010	4	3	7
2011	2	2	4
Totals	**9**	**14**	**23**

Source: FDIC Legal Division, Executive Secretary Section.

Of the 23 appeals, 11 were completed as follows: 4 risk management appeals and 6 compliance/CRA appeals were denied and 1 compliance/CRA appeal was partially sustained. The remaining 12 appeals were not completed for the following reasons:

- 9 appeals were found to be not appealable under the Guidelines for Appeals,
- 2 institutions were closed, and
- 1 institution withdrew its appeal.

In reviewing the SARC determinations for appeals that were denied, we noted that the appeals related to risk management examinations were generally denied because the SARC found that component and composite ratings were fully supported, loan classification decisions were well-founded, growth limitations were properly imposed, and interest rate restrictions were correct. With respect to compliance/CRA examinations, the SARC found that compliance ratings were well-founded and consistent with regulatory requirements, there was a reasonable basis for citing violations, and the bank's CRA performance was appropriately evaluated. These determinations provide evidence that the SARC is considering the underlying merits of both the institution and the examiners' positions and, as such, is considering the substance of the disagreement and not simply whether or not the examiners followed established policy.

Regarding the timeframes for processing the 11 completed SARC appeals, 8 appeals were filed before the April 2010 timeframe revisions and 3 appeals were filed afterwards. Of the 8 appeals, 7 exceeded the 60-day decisional deadline after the oral hearing, with 3 appeals exceeding the deadline by 2 to 37 days and 4 appeals exceeding the deadline by 71 to 128 days. The 3 appeals filed after the April 2010 timeframe revisions were all completed by the SARC within the 135-day combined timeframe allowed by the April 2010 revisions.

Regarding the requests for review and SARC appeals that exceeded the applicable timeframes in 2007-2009, RMS officials stated that these instances were largely due to the workload associated with the financial crisis and related CAMELS rating changes. Since the timeframe changes were implemented in April 2010, the FDIC has satisfactorily met the new timeframes with one minor exception and no further adjustments to the timeframes are expected.

Other Avenues for Questioning Examination Results

In addition to the informal and formal appeals processes, FDIC-supervised institutions have other avenues for questioning examination results, including the ALJ, the OO, and other components of the FDIC.

Administrative Law Judge Process

FIRREA directed the federal banking agencies to "establish their own pool of administrative law judges" to conduct hearings related to formal enforcement actions. In 1991, OFIA was created as the executive body responsible for processing administrative enforcement proceedings brought by the FDIC, OCC, FRB, or NCUA.[20] After an agency initiates a public administrative proceeding, it refers the case to OFIA. The OFIA ALJ then conducts public hearings at locations throughout the United States in a manner similar to non-jury trials in the federal district courts. The ALJ prepares a recommended decision to the Board or Comptroller of the appropriate federal banking agency, with factual findings and legal conclusions that are matters of public record. The parties may file exceptions to the recommended decision with the Board or Comptroller of the appropriate federal banking agency, which can affirm, reverse, modify, set aside, or remand the matter for further proceedings. Any appeals of a final federal banking agency action are made to a United States Circuit Court of Appeals.

Table 8 shows the number and status of FDIC enforcement action cases that were referred to OFIA in 2007-2011.

[20] OFIA also adjudicated cases brought by the Office of Thrift Supervision before it was abolished in July 2011.

Table 8: FDIC Enforcement Action Cases Referred to OFIA, 2007-2011

Status	2007	2008	2009	2010	2011
Settled Before Hearing		1	11	10	11
Pending Hearing					4
Hearing Held:					
- Upheld FDIC Decision on the Merits	1	1	1		
- Defaulted to FDIC Decision (respondent did not appear)		1		1	
- Terminated by ALJ*				1*	
- Decision Pending				1	2
Total Cases	**1**	**3**	**12**	**13**	**17**

Source: FDIC Legal Division, Supervision Branch.

* ALJs may terminate cases involving CMPs in which the respondent fails to respond, as happened in this case. As a result, the FDIC proceeded with the CMP.

As indicated in Table 8, most FDIC enforcement action cases referred to OFIA were settled with the institution before a hearing took place, while cases with ALJ hearings have generally been resolved in the FDIC's favor. There are also three cases from 2010-2011 for which the ALJ's decision is pending.

Office of the Ombudsman

Within the FDIC, the OO serves as an independent, neutral, and confidential resource and liaison for the banking industry and the general public. However, the OO is not an appeals function. The OO is organizationally separate from other FDIC divisions and offices, enabling the Office to operate free from the influence, control, or guidance of the FDIC program areas.

The OO instructs its staff to respond to inquiries about the FDIC in a fair, impartial, and timely manner. The office researches questions and considers complaints from bankers and bank customers. Contact with the OO does not prevent an inquirer from pursuing formal resolution channels within the FDIC, nor does it constitute initiation of a formal complaint, grievance, or appeal process, or forestall the time limits for pursuing formal resolutions that are established within those formal processes.

The OO serves as a neutral advocate for fair processes. In that role, OO staff assists in identifying options to resolve disputes, but does not take sides with respect to the outcome. The office's ability to compile information, negotiate effective resolutions, and provide options is dependent upon its status as a neutral and independent entity.

The OO also has regional ombudsmen in place in all six FDIC regional offices. The regional office ombudsmen are responsible for an outreach program that seeks to make contact with all FDIC-supervised institutions. Table 9 presents the frequency with which bankers expressed concerns about various types of FDIC examinations during outreach meetings in 2007-2011.

Table 9: Examination Concerns Noted During Outreach Meetings, 2007-2011

Area of Concern	2007	2008	2009	2010	2011
Risk Management	36	48	21	30	71
Compliance	3	2	2	10	17
Community Reinvestment Act	3	1	0	0	3
Specialty Examinations	10	1	0	2	1
General Examination Process	145	86	30	48	67
Total Instances	**197**	**138**	**53**	**90**	**159**

Source: FDIC OO.

In addition, OO representatives are present at all bank closings to provide accurate information to bank customers, the media, bank employees, and the general public.

The OO prepares a quarterly report for the FDIC's divisions and offices summarizing topics and issues raised through the OO's various outreach activities and contacts from the public and banking industry. The OO's fourth quarter 2011 report indicated that common concerns or complaints from bankers included:

- frustration regarding the focus of examinations,
- varying interpretations of regulations by examiners, and
- apprehension about consumer regulations resulting from the Dodd-Frank Act.

Many of the OO's contacts originate from its toll-free number. In addition, the OO receives some calls through the FDIC Central Call Center in Arlington, Virginia. The Call Center is one of many FDIC resources available to the banking community for general questions. Other resources include field supervisors and examiners, RMS case managers and DCP review examiners, and other supervisory personnel at the regional or headquarters offices. Based on the information it receives from various sources, the OO may suggest ways to improve FDIC operations, regulations, and customer service; however, because of its confidentiality mandate, the OO is unable to provide specific information regarding which banks have expressed concerns.

Table 10 summarizes the frequency of contacts and several of the major issue areas noted by OO staff for the period 2007-2011.

Table 10: Summary of OO Contacts by Major Issue Areas, 2007-2011

Issue Area	2007	2008	2009	2010	2011
Bank Examinations					
- Risk Management/Specialty	22	17	24	27	28
- Compliance/CRA	8	8	7	22	19
- General Examination Process	21	12	11	4	9
Working Relationships and Communication	5	8	8	21	22
Material Supervisory Determinations	4	5	4	5	3
Appraisals	20	16	4	7	21
Other Regulatory Matters	506	412	187	289	274
Total for Issue Areas Above	**586**	**478**	**245**	**375**	**376**
Other Contacts	**317**	**414**	**362**	**513**	**453**
Total Contacts	**903**	**892**	**607**	**888**	**829**

Source: FDIC OO and the Ombudsman Automated Tracking System (OATS).

Other Points of Contact

The FDIC Office of Legislative Affairs (OLA) receives inquiries and requests from the Congress related to community banks, including requests forwarded from banks or bank associations. OLA works with appropriate division and office personnel to respond fully and promptly to these inquiries and requests. Additionally, bankers may sometimes directly contact the RMS or DCP Directors or the Office of the Chairman to discuss various issues and concerns.

FDIC Initiatives Related to Community Banks

While not directly related to our audit objectives, we considered it important to discuss various initiatives undertaken by the FDIC to further its dialogue and efforts to better understand the challenges and opportunities facing community banks. Recognizing that community banks play a crucial role in the nation's financial system and economy, the FDIC Acting Chairman views the FDIC as having a responsibility to use its resources to gain a better understanding of the challenges facing community banks and to share that understanding with the banks as well as the general public.

FDIC Advisory Committee on Community Banking

In May 2009, the FDIC BOD approved the establishment of the FDIC Advisory Committee on Community Banking, which provides the FDIC with advice and recommendations on a broad range of policy issues impacting small community banks throughout the country. The Committee reviews various matters that include the latest examination policies and procedures, lending practices, and regulatory compliance issues, as well as any obstacles to the continued growth and ability of community banks to extend financial services in their local markets in the current environment.

The majority of the members of the Committee represent community banks of various sizes and charter types, including a cross-section of institutions from different regions of the country. Other members of the Committee may include representatives of the public sector, small businesses, non-for-profit community organizations, or other entities that rely on community banks to provide credit and other banking services in their communities, as well as one or more representatives from academic institutions.

Other Initiatives

The Acting Chairman has taken additional steps to ensure that the FDIC and others significant to the financial industry identify and discuss important community banking-related issues and take action to address those issues. These steps include:

- dialogues with community bankers and the stakeholders of community banks,
- a Future of Community Banking conference held at the FDIC in early 2012,
- research projects focused on community banks and their local economies,
- streamlined supervision and rulemaking processes, and
- the collection of information regarding the obstacles that financial institutions face in making loans available to creditworthy borrowers.

In consideration of recent and forthcoming regulatory changes, the FDIC is also developing guidance for its examiners that considers the needs of community banks to help them understand and appropriately implement new and revised rules and regulations.

To reinforce the importance of these community banking initiatives, the *2012 FDIC Performance Goals* include a specific goal to "Deepen the FDIC's Understanding of the Future of Community Banking." As a performance goal, the results of the FDIC's community banking initiatives will be measured and tracked to assess the Corporation's accomplishments.

Corporation Comments and OIG Evaluation

Subsequent to the issuance of our draft report, FDIC officials provided additional information for our consideration, and we revised our report to reflect this information, as appropriate. On August 29, 2012, the RMS Director provided a written response to a draft of this report on behalf of the Corporation. That response is provided in its entirety in Appendix 9.

In the response, the RMS Director noted the thoroughness of the draft report and concurred with our observations about increased examination cycle and report processing timeframes. The Director also acknowledged the information in the report regarding quality control practices that promote consistency in the examination process and encourage examiners and bankers to informally resolve disputes during examinations. Concerning our observations on the formal dispute resolution process, the Director confirmed that changes to the decisional deadlines have enabled formal reviews and appeals to be processed within applicable timeframes.

Objectives, Scope, and Methodology

Objectives

Our audit objectives were to report on:

- the FDIC's examination process for small community banks, including examination timelines and how the FDIC ensures consistency in the administration of examinations across the country; and

- the ability of FDIC-supervised institutions to question examination results, such as through the OO, the appeals process, or informal channels, and the frequency and success of such appeals.

We conducted this performance audit from March 2012 to August 2012 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. Consistent with our audit objectives, we did not conduct tests to conclude on (1) the adequacy or effectiveness of the FDIC's examination or appeals processes, (2) actions taken by the FDIC to address any prior self-identified deficiencies in its examination and appeals processes, or (3) matters included in prior audit reports. Although our audit objectives did not require us to develop findings and conclusions, we believe that the evidence obtained provides a reasonable basis for our observations in this report.

Scope and Methodology

The scope of our review, 2007-2011, was selected to take into account examination timeframes and appeals processes both before and during the financial crisis. Our methodology included data-gathering techniques to obtain an understanding of the FDIC's overall examination and supervision activities and the ability of FDIC-supervised financial institutions to question examination results.

To achieve the objectives, we performed the following procedures and techniques:

- Interviewed and obtained specific statistical information from RMS, DCP, Legal Division, and OO headquarters officials.

- Interviewed RMS officials in the Atlanta, Chicago, and Dallas Regional Offices, and the OFIA ALJ.

- Interviewed a Legal Division official from the Atlanta Regional Office.

Objectives, Scope, and Methodology

In addition, we reviewed:

- examination manuals such as the *Risk Management Manual of Examination Policies*, *Compliance Examination Manual, Case Manager Procedures Manual*, and *Formal and Informal Action Procedures Manual*;

- information regarding the benchmarks and actual hours spent on examinations and the average turnaround days for RMS and DCP examinations, including the number of days spent onsite, for report processing, and the total examination cycle (i.e., combined onsite and report processing time);

- information from the FDIC's Web site related to controls that the Corporation has implemented to address examination and supervision consistency, including applicable laws and rules and regulations, policies, procedures, examiner and financial institution guidance, examiner training activities, supervisory review, supervisory and enforcement actions, and quality assurance activities;

- information related to the FDIC's policies, procedures, and processes for financial institutions to informally and formally question examination results;

- FDIC participation in, and coordination with, external councils, including the FFIEC and other working groups;

- statistical data on the number, days, and resolution of appeals filed by FDIC-supervised financial institutions;

- numerical data on the number of contacts with bankers and the public handled by the OO; and

- information on the FDIC's initiatives related to community banks.

Internal Control, Reliance on Computer-processed Information, Performance Measurement, and Compliance with Laws and Regulations

We gathered information regarding the FDIC's internal control framework for risk management and compliance/CRA examinations. However, consistent with the stated audit objectives, we did not assess the FDIC's overall internal control or management control structure. We obtained data maintained by the RMS Business Analysis and Decision Support Section on examination timeframes, which was largely drawn from

Objectives, Scope, and Methodology

ViSION,[21] and we also obtained data maintained by the OO in OATS on contacts with bankers and the public. However, we did not assess the effectiveness of information system controls as this was not part of our audit objectives. We also obtained informal data maintained by RMS and the Legal Division pertaining to appeals and ALJ cases, and we verified the data against the available hardcopy files provided to us on appeals.

The Government Performance and Results Act of 1993 (the Results Act) directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. For this audit, we reviewed the *FDIC Strategic Plan 2008-2013*, *2011 Annual Performance Plan*, and *2012 Annual Performance Plan*. We also reviewed RMS's 2010 Performance Results. We did not assess the strengths and weaknesses of the FDIC's strategic and annual plans or the Corporation's mission and goals in meeting the requirements of the Results Act because such an assessment was not part of the audit objectives.

Regarding compliance with laws and regulations, we did not perform tests to determine whether the FDIC had complied with provisions of the FDI Act, the Riegle Act, the Dodd-Frank Act, or the FDIC Rules and Regulations as such an assessment was not necessary to achieve the audit objectives. Additionally, we did not specifically assess the risk of fraud and abuse related to our objectives. However, during the audit, we were alert to the possibility of fraud and illegal acts, and no instances came to our attention.

[21] See the FDIC OIG's audit report, *Reliability of Supervisory Information Accessed Through the Virtual Supervisory Information on the Net (ViSION) System* (AUD-08-019, dated September 25, 2008), for recommendations made to enhance the accuracy of data in ViSION.

The FDIC's Examination Processes

Risk Management Examination Process

RMS conducts risk management examinations to ensure that the institutions it supervises are operating in a safe and sound manner and are complying with banking laws and regulations in the provision of financial services.[22] Section 10(d) of the Federal Deposit Insurance Act (the FDI Act) requires periodic, full-scope, onsite examinations of each insured depository institution. These examinations serve to evaluate an institution's overall risk exposure and its ability to identify and manage those risks.[23]

On October 1, 1997, the FDIC, in conjunction with the FRB and Conference of State Bank Supervisors, began implementing a risk-focused examination process designed to focus their examinations on bank functions that posed the greatest risk exposure. The risk-focused examination process attempts to assess an institution's risk by evaluating its processes to identify, measure, monitor, and control risk. If management controls are properly designed and effectively applied, they should help ensure that satisfactory performance is achieved. In a rapidly changing environment, a bank's condition at any given point in time may not be indicative of its future performance. The risk-focused examination process seeks to strike an appropriate balance between evaluating the condition of an institution at a certain point in time and evaluating the soundness of the institution's processes for managing risk.

The examination process can be separated into three distinct phases: pre-examination planning, onsite fieldwork, and development and review of the examination report. A brief description of these phases follows.[24]

Pre-Examination Planning. According to the FDIC's Examination Manual, thorough pre-examination planning is critical to the efficient completion of an examination. Pre-examination planning helps support decisions on the work to be performed and areas to receive special attention. Such planning also helps determine staffing needs regarding the size and expertise of the examination team. To guide its examiners in conducting pre-examination planning, the FDIC has an ED Module entitled, *Risk Scoping Activities*, which was developed in conjunction with the FRB and state banking departments. This ED Module identifies several activities to be completed during pre-examination planning, including:

- reviewing various information sources to identify the significant and higher-risk activities of the bank;

[22] The FDIC may also conduct examinations of state member banks and federally-chartered banks and thrifts, when needed for insurance purposes.
[23] As noted in the body of the report, examiners also rely on off-site monitoring to identify emerging risks and establish supervisory strategies to mitigate them.
[24] Refer to http://www.fdic.gov/regulations/examinations/index.html to learn more about how the FDIC examines financial institutions.

The FDIC's Examination Processes

- scheduling a pre-examination contact with bank management to discuss economic conditions, operational changes, and the highest-risk areas;

- reviewing the findings of internal and external auditors;

- determining the perceived control risks within the bank based on specific internal control weaknesses identified by audits, the prior examination, or other control procedures; and

- reviewing information regarding consumer complaints or problems and determining the potential for safety and soundness concerns.

Pre-examination planning culminates in the preparation of a scope memorandum, also called a pre-examination planning memo. According to the ED Module, the scope memorandum should be tailored to the size and complexity of the bank and define the objectives of the examination.

Onsite Fieldwork. Under the risk-focused examination process, FDIC examiners focus less on specific transactions and more on an institution's control processes. Specifically, this examination approach includes:

- more focus on BOD and management oversight;

- less transaction testing, with a focus on areas identified during pre-examination planning as having the most risk;

- a reduced percentage of loans and files reviewed; and

- fewer procedures, such as balancing accounts.

The start of onsite fieldwork is tracked as the Examination Start Date. This date indicates when the examination commenced, which is the date the examination team begins its formal onsite examination of the institution. The Examination Start Date is used to monitor report completion timeframes and compliance with examination frequency requirements.

Development and Review of the Examination Report. The onsite phase of the examination typically concludes with an exit meeting with management and the examination team's completion of the draft examination report. This date is tracked as the Date Examination Completed, which is the date on which the EIC submits the draft report for RMS supervisory review. The Date Examination Completed is used to monitor report processing timeframes.

The FDIC's Examination Processes

Depending on the asset size of the bank and its overall CAMELS rating, the draft report will be reviewed by RMS senior officials at the field office and/or regional office before it is issued to the institution as a final report. The final report issuance date is tracked as Date Mailed, which is when the report is mailed to the bank along with a transmittal letter and post-examination survey.

Compliance Examination Process

DCP conducts compliance examinations to:

- assess the quality of an FDIC-supervised institution's compliance management system for implementing federal consumer protection statutes and regulations;
- review compliance with relevant laws and regulations; and
- initiate supervisory action when elements of an institution's compliance management system are deficient or when significant violations of law are found.

Institutions supervised by the FDIC are examined at intervals established by policy approved by the FDIC's Board of Directors. Depending on a combination of their compliance and CRA ratings, DCP conducts compliance examinations of these institutions in cycles ranging from 12 to 36 months. However, as mandated by the Gramm-Leach-Bliley Act of 1999, CRA performance evaluations for institutions with total assets of $250 million or less can be conducted no more often than every 5 years for institutions rated "Outstanding" and no more often than every 4 years for institutions rated "Satisfactory." As a result, CRA performance evaluations for these smaller institutions are usually paired with alternating compliance examinations, while CRA performance evaluations for all other institutions are usually conducted concurrently with each compliance examination. Also, the rating systems for compliance and CRA examinations differ, as follows:

- compliance examinations provide a rating from 1 to 5, with 1 indicating a strong compliance position and 5 indicating an institution in need of the strongest supervisory attention; while
- CRA performance evaluations provide ratings of Outstanding, Satisfactory, Needs to Improve, or Substantial Noncompliance, reflecting the institution's record of helping to meet the credit needs of its assessment area.

DCP's compliance examinations blend risk-focused and process-oriented approaches. Risk-focusing involves using information gathered about a financial institution to direct FDIC examiner resources to those operational areas that present the greatest compliance risks. Concentrating on the institution's internal control infrastructure and methods, which is the process used to ensure compliance with federal consumer protection laws

The FDIC's Examination Processes

and regulations, acknowledges that the ultimate responsibility for compliance rests with the institution and encourages examination efficiency.

Risk-focusing involves:

- developing a compliance risk profile for an institution using various sources of information about its business lines, organizational structure, operations, and past supervisory performance;

- assessing the quality of an institution's compliance management system in light of the risks associated with the level and complexity of its business operations and product and service offerings; and

- testing selected transactions based on risk, such as when an operational area is determined to be high-risk and the institution's compliance management efforts appear weak.

Compliance examinations primarily involve three stages: pre-examination planning; review and analysis, both offsite and onsite; and communicating findings to institution management through meetings and an examination report. Although compliance and risk management examinations each have a different focus, the process for conducting compliance examinations follows the same general phases identified above for risk management examinations, except that the offsite review and analysis is considered part of the second phase. For ease of understanding, we have broken this phase into two parts below. DCP management confirmed that these compliance examination processes have been consistent for the 5-year scope of our review. The OIG plans to begin audit coverage of DCP's operations in 2013.

Pre-Examination Planning. Pre-examination planning involves gathering information available in FDIC records and databases, contacting the financial institution to review and narrow the draft request for information and documents, and delivering a letter to the institution requesting specific information and documents for detailed analysis by the examination team.

Review and Analysis – Offsite. During the review and analysis phase of a compliance examination, the examiner thoroughly evaluates an institution's compliance management system to assess its quality and effectiveness and documents system weaknesses and violations of federal consumer protection laws and regulations. The EIC starts by analyzing information about the type, level, and complexity of the institution's operations, and begins to develop the scope of the examination and plan for resource deployment to areas of highest risk. The examination scope will be preliminarily established prior to entering the financial institution and should be refined through the results of examiner discussions with the bank's senior management, compliance officer, and internal auditor.

The FDIC's Examination Processes

Review and Analysis – Onsite. While onsite at the institution, the examiner may limit the scope of the compliance review based on reliable procedures and controls in place. Similarly, the examiner may expand the review based on, for example, management's views about compliance, a lack of necessary procedures or controls, the presence of violations, or the presence of new or significantly amended regulations. The examiner must consider the size, level, and complexity of an institution's operations when evaluating the adequacy of an institution's compliance management system. The number of transactions selected and the type of sampling used should be relative to the perceived risk and the need to assess the level of compliance in an activity or function.

At the conclusion of the review and analysis phase, an examiner:

- summarizes all findings regarding the strengths and weaknesses of an institution's compliance management system;
- determines the causes of programmatic deficiencies or violations and relates them to the specific weaknesses in the banks' compliance management system; and
- identifies actions necessary to address deficiencies or violations.

Determining the causes of program deficiencies or violations is critical to recommending solutions that will successfully address problem areas and strengthen an institution's compliance posture for the future.

Communicating Findings. During this phase, the examiners must discuss findings and recommendations with management and obtain a commitment for corrective action. These discussions will be held during the course of the examination and at an exit meeting with senior management and/or the institution's BOD.

The results of the examination will also be communicated to the BOD and management of the institution in an examination report. The examination report provides an account of the strengths and weaknesses of a compliance management system. It is more than an exception-based document and should add value to the institution's compliance efforts.

Key dates used to track compliance examinations are the same as for risk management examinations. Specifically, key dates measure the time from the Examination Start Date (when the examination team begins onsite work at the institution), to the Date Examination Completed (when the draft report is submitted for supervisory review), to the Date Mailed (when the final report is sent to the institution).

Laws and Rules and Regulations

Examples of the laws and rules and regulations[25] applicable to the FDIC's examination and supervision processes are provided in Table 11.

Table 11: Examples of Laws and Rules and Regulations Applicable to the FDIC's Examination and Supervision Processes

Law or Rules and Regulations	Description
FDI Act Sections	
Section 8	The FDIC may issue the following formal actions: termination of federal deposit insurance; cease-and-desist/consent actions; removal, prohibition, and suspension actions; and CMPs. Although not specifically authorized by section 8, the FDIC also may issue informal supervisory actions such as BBRs and MOUs.
Section 10(c)	The FDIC may conduct an investigation outside the scope of an examination to obtain information related to a community bank's operations and/or its directors, officers, and employees.
Section 38	This section authorizes the FDIC to issue PCA directives to institutions that are deemed to be in one of three *Undercapitalized* categories.[26] Section 38 established PCA, which emphasizes early intervention and regulatory oversight to reduce the prospect of long-term losses to the DIF. PCA requires or permits certain supervisory actions based upon an insured institution's capital level. As the financial condition declines, the corrective measures become more stringent. Ultimately, the appointment of a conservator or a receiver may be required.
FDIC Rules and Regulations	
Part 325 – *Capital Maintenance*	Applies to those circumstances for which the FDI Act or the FDIC Rules and Regulations require an evaluation of the adequacy of an insured depository institution's capital structure. The FDIC is required to evaluate an institution's capital position before approving various applications by insured depository institutions. The FDIC must also evaluate capital as an essential component in determining the safety and soundness of the state nonmember banks it insures and supervises, including PCA compliance.
Section 326.8 – *BSA Compliance*	Requires each FDIC-supervised institution to develop and administer a program to ensure compliance with the BSA and 31 CFR Part 103. The institution's BOD must approve the compliance program in writing, and the program should include four minimum requirements: a system of internal controls, independent testing, designation of individuals responsible for coordinating and monitoring compliance, and training.
Section 337.6 – *Brokered Deposits*	Section 29 of the FDI Act and Part 337.6 of the FDIC Rules and Regulations address restrictions placed on banks deemed to be less than *Well Capitalized* for PCA purposes, including brokered deposits and interest-rate risk restrictions.
Part 364 – *Standards for Safety and Soundness*	As prescribed by Part 364 of the FDIC Rules and Regulations, the federal banking agencies were required to establish certain safety and soundness standards by regulation or by guidelines for all insured depository institutions. More specifically, the FDIC and other federal banking agencies have established appropriate operational and managerial, compensation, and asset quality, earnings, and stock valuation standards.

[25] Refer to http://www.fdic.gov/regulations/laws/rules/index.html for additional information regarding applicable laws and rules and regulations.

[26] Part 325, subpart B, of the FDIC Rules and Regulations, 12 Code of Federal Regulations (CFR) section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 United States Code (USC) section 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe a financial institution's capital adequacy: (1) *Well Capitalized*, (2) *Adequately Capitalized*, (3) *Undercapitalized*, (4) *Significantly Undercapitalized*, and (5) *Critically Undercapitalized*.

Laws and Rules and Regulations

Table 11: Examples of Laws and Rules and Regulations Applicable to the FDIC's Examination and Supervision Processes

Law or Rules and Regulations	Description
Consumer Protection Laws	
Community Reinvestment Act	The Community Reinvestment Act encourages federally insured banks to meet the credit needs of their entire community. Part 345 of the FDIC Rules and Regulations states that each appropriate federal financial supervisory agency is required to assess an institution's record of helping to meet the credit needs of the local communities in which the institution is chartered, consistent with the safe and sound operation of the institution, and to take this record into account in the agency's evaluation of an application for a deposit facility by the institution.
Equal Credit Opportunity Act (Regulation B)	The Equal Credit Opportunity Act prohibits certain discriminatory practices, including creditor practices that discriminate based on race, color, religion, national origin, sex, marital status, or age.
Fair and Accurate Credit Transaction Act	The Fair and Accurate Credit Transaction Act strengthened the country's national credit reporting system and assists financial institutions and consumers in the fight against identity theft.
Fair Housing Act	The Fair Housing Act prohibits discrimination based on race, color, religion, national origin, sex, familial status, and handicap in residential real-estate-related transactions.
Home Mortgage Disclosure Act (Regulation C)	The Home Mortgage Disclosure Act was enacted to provide information to the public and federal regulators regarding how depository institutions are fulfilling their obligations towards community housing needs. The regulation requires an institution to report data to its supervisory agency about home purchase loans, home improvement loans, and refinancings that it originates or purchases, or for which it receives applications; and to disclose certain data to the public.
Real Estate Settlement Procedures Act (RESPA)	RESPA covers loans secured with a mortgage placed on a one-to-four family residential property. These include most home purchase loans, assumptions, refinances, property improvement loans, and equity lines of credit. RESPA requires that borrowers receive disclosures at various times. Some disclosures spell out the costs associated with the settlement, outline lender servicing and escrow account practices, and describe business relationships between settlement service providers.
Truth in Lending Act (Regulation Z)	Contained in Title I of the Consumer Credit Protection Act, the Truth in Lending Act requires meaningful disclosure of credit and leasing terms. According to Section 226.1 of the FDIC Rules and Regulations, the purpose of the implementing regulations is to promote the informed use of consumer credit by requiring disclosures about its terms and cost. The regulations also include substantive protections to consumers.
Unfair or Deceptive Acts or Practices (Regulation AA)	Section 5 of the Federal Trade Commission Act (FTC Act) prohibits unfair or deceptive acts or practices in or affecting commerce. The prohibitions apply to all persons engaged in commerce, including banks. The prohibitions do not limit any agency's authority to enforce the FTC Act with respect to any other unfair or deceptive acts or practices. An act or practice is unfair where it causes or is likely to cause substantial injury to consumers, cannot be reasonably avoided by consumers, and is not outweighed by countervailing benefits to consumers or to competition. An act or practice is deceptive where a representation, omission, or practice misleads or is likely to mislead the consumer or the consumer's interpretation of the representation, omission, or practice, and the misleading representation, omission, or practice is material.

Sources: FDIC OIG review of the FDI Act and FDIC Rules and Regulations; FDIC OIG Semiannual Report to the Congress, April 1, 2008 – September 30, 2008; Department of Housing and Urban Development Web site; Federal Trade Commission Web site; and coordination with DCP officials.

Examiner and Financial Institution Guidance

The FDIC uses various means, some of which are indicated below, to communicate policy and examination guidance to its examination staff and supervised and insured financial institutions.

RD Memoranda and FILs. The FDIC has issued extensive guidance in the form of RD Memoranda and FILs to assist examiners and financial institutions in carrying out their responsibilities. RD Memoranda and FILs have been issued on a variety of matters of principal interest to those responsible for examining or operating a bank or savings association such as, but not limited to, the UFIRS (CAMELS) rating system; capital, de novo financial institutions, executive compensation, enforcement actions, PCA, and BSA/AML compliance.

Examination Manuals. The FDIC has issued extensive guidance in the form of examination manuals to assist examiners in conducting examinations of financial institutions and making appropriate decisions regarding the supervision of those institutions. For example:

- The *Risk Management Manual of Examination Policies* provides guidance on such significant issues as, but not limited to, basic examination concepts and guidelines, CAMELS, risk-scoping activities, visitations, limited scope examinations, de novo financial institutions, reliance on and acceptance of state examinations, and examination work papers. Although this manual provides policy guidance and direction to examiners that should be applied in the risk management examination process, other manuals and/or policy pertaining to additional areas of examination interest, such as trust department operations, brokered deposits, commercial real estate, and loan modifications have also been developed.[27]

- The *Compliance Examination Manual* provides guidance on issues such as, but not limited to, community reinvestment; fair lending laws and regulations; compliance lending issues, including truth in lending, real estate settlement procedures, homeowners protection, flood insurance, and home mortgage disclosure; abusive lending practices; and consumer privacy issues.[28]

- The FFIEC *BSA/Anti-Money Laundering Examination Manual* (BSA/AML Manual) provides guidance for BSA/AML-related examinations. The manual also provides guidance on identifying and controlling risks associated with money laundering and terrorist financing. The manual contains an overview of BSA/AML compliance program requirements, BSA/AML risks and risk management expectations, industry sound practices, and examination procedures.

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[27] Refer to http://www.fdic.gov/regulations/safety/manual/ for additional information regarding the *Risk Management Manual of Examination Policies*.
[28] Refer to http://www.fdic.gov/regulations/compliance/manual/index_pdf.html for additional information on the FDIC's *Compliance Examination Manual*.

Examiner and Financial Institution Guidance

The manual was developed through a collaborative effort by the federal and state banking agencies and the Financial Crimes Enforcement Network, a bureau of the U.S. Department of the Treasury, to ensure consistency in the application of the BSA/AML requirements.[29]

- The *Case Manager Procedures Manual*[30] provides guidance to case managers who are responsible for assisting in the identification of risk and supervision for a caseload of banks assigned to them. According to the manual:

    - The primary goal of the FDIC's Case Manager program is to enhance risk assessment and supervision activities by assigning responsibility and accountability for a caseload of institutions or companies to one individual, regardless of charter and location, and by encouraging a more proactive, but non-intrusive, coordinated supervisory approach.

    - An equally important goal of this program is to promote better communication and coordination between the FDIC, other regulators, and the banking industry so that a consistent regulatory voice is presented, while minimizing regulatory burden to the extent possible.

    - The emphasis of the program is to ensure that the level of regulatory oversight applied to an institution is commensurate with the level of risk it poses to the DIF.

- The FIAP Manual[31] provides guidance on formal and informal corrective actions, such as cease and desist orders, termination of insurance coverage, PCA, CMPs, BBRs, and MOUs. The FIAP Manual is intended to support the FDIC's field, regional, and headquarters offices in their efforts to determine the authorities and circumstances under which formal or informal actions should be considered and/or the monitoring of actions imposed against FDIC-supervised financial institutions.

Examination Documentation (ED) Modules. The ED Modules[32] are an examination tool that focuses on risk management practices and guides examiners to establish the appropriate examination scope. The modules incorporate questions and points of consideration into examination procedures to specifically address a bank's risk management strategies for each of its major business activities. Although examiner use of the ED Modules is discretionary, the modules direct examiners to consider areas of

[29] Refer to http://www.ffiec.gov/bsa_aml_infobase/default.htm for additional information regarding the BSA/AML Manual. The Department of the Treasury's Office of Foreign Assets Control (OFAC) also assisted in developing sections of the BSA/AML Manual that relate to OFAC reviews.
[30] The FDIC's *Case Manager Procedures Manual* is not available online.
[31] The FDIC's FIAP Manual is not available online.
[32] The FDIC's *ED Modules* are not available online.

Examiner and Financial Institution Guidance

potential and associated risk control practices, thereby facilitating a more effective supervisory program. Guidance included in the ED Modules addresses issues such as:

- risk scoping activities,
- capital adequacy,
- loan portfolio management and review,
- earnings and liquidity,
- commercial and residential real estate lending,
- real estate appraisals, and
- subprime lending.

Examiner Training

The FDIC recognizes that training is an essential component of employee development and effective bank supervision and is committed to developing and maintaining a qualified examination workforce. The information presented below provides a synopsis of some of the methods that the FDIC uses to provide examiner training activities.[33]

FDIC Corporate University. The FDIC launched the Corporate University during the second quarter of 2003 to provide a more customized approach to training the FDIC's workforce. The Corporate University offers career-long learning and development opportunities to meet the FDIC's workforce needs; new employee and skills training; and career, professional, and leadership development. In addition, the Corporate University has primary responsibility for the effective and efficient establishment, implementation, design, deliverance, maintenance, and evaluation of the FDIC's learning and professional development programs. The Corporate University provides opportunities for employees to learn more about the FDIC's major program areas of supervision (risk management and compliance), resolutions, and insurance and offers various courses related to each of these areas.

Required Curriculum for Commissioned Examiners. The FDIC has established a risk management and compliance training program in which examiners complete a specific course curriculum and OJT before becoming commissioned examiners. The curriculum consists of (1) introduction to examinations, (2) financial institution analysis, (3) loan analysis, (4) examination management, and (5) asset liability management. The curriculum for compliance pre-commissioned examiners includes: (1) introduction to compliance examinations, (2) compliance management, (3) CRA, and (4) fair lending. In addition, these courses include examiners from other federal and state regulatory agencies, contributing to a consistent framework of instruction and a cross-sharing of experiences.

Established Benchmarks. The FDIC issued benchmarks for risk management and compliance examiner training in August 2004 that outline the duties and responsibilities that fully successful examiners must demonstrate at each level of their career. The FDIC periodically updates the benchmarks to provide additional guidance to examiners regarding training requirements.

OJT Guides. The FDIC has published OJT guides for both RMS and compliance/CRA-related examinations. In June 2010, DSC (now RMS) updated online OJT reference guides for risk management and compliance examinations.

- The OJT guides provide instruction on issues such as allowance for loan and lease losses, capital, liquidity, loan analysis, and internal controls. According to the June 2010 transmittal memorandum, the OJT guide is an informal tool for pre-commissioned examiners, including assistant examiners, mid-career

[33] Refer to http://www.fdic.gov/regulations/examiner/ for additional information on the FDIC's examiner training activities.

Examiner Training

examiners, newly-hired examiners, and interns. The optional use of the guide, along with classroom-based instruction, promotes consistent training for examination staff. The RMS guide is not intended to be a "step-by-step instruction manual" and should be used in conjunction with other FDIC guidance such as the Examination Manual, outstanding examination guidelines, and the ED Modules.

- The FDIC's compliance OJT guide is designed to support the pre-commissioned examiner's development through the commissioning process. According to the June 2010 update, the compliance guide is a formal OJT tool for pre-commissioned examiners, including assistant examiners, mid-career examiners, newly-hired examiners, and interns. The compliance guide identifies examination tasks and instructions for pre-commissioned examiners, as well as coaching guidelines for supervisors and trainers, but is not intended to be a "how to manual" or the sole resource needed for commissioning requirements. The training modules in the guide are not all-inclusive of a pre-commissioned examiner's ongoing duties and responsibilities and should be used in conjunction with other examination resources, including online and classroom instruction. The guide is a mandatory training tool for pre-commissioned compliance examiners.

FFIEC Task Forces

The FFIEC has six task forces that assist the Council in achieving its mission. More specifically, each task force is composed of six senior officials, consisting of representatives from each of the five member agencies and a representative of the SLC. As indicated in Table 12, each of the six FFIEC Task Forces is responsible for addressing/overseeing matters of great significance and that contribute to examination and supervision consistency.

Table 12: FFIEC Task Forces and Related Responsibilities and Duties

FFIEC TASK FORCE	DESCRIPTION OF TASK FORCE
Examiner Education	Responsible for overseeing the FFIEC's examiner education program on behalf of the Council. The task force promotes interagency education through timely, cost-efficient, state-of-the-art training programs for agency examiners and staff. The task force develops programs on its own initiative and in response to requests from the Council, Council task forces, and suggestions brought forth by Examiner Education Office staff. The task force staff schedules, delivers, and evaluates training programs throughout the year. In 2011, the number of people who attended task force-sponsored training totaled 3,164.
Supervision	Coordinates and oversees matters relating to safety and soundness supervision and examination of depository institutions. It provides a forum for Council members to promote quality, consistency, and effectiveness in examination and supervisory practices. While significant issues are referred, with recommendations, to the Council for action, the Council has delegated to the task force the authority to make certain decisions and recommendations, provided all task force members agree.
Reports	The law establishing the Council and defining its functions requires the Council to develop uniform reporting systems for federally supervised financial institutions and their holding companies and subsidiaries. Accordingly, the Council established the Task Force on Reports, which helps to develop inter-agency uniformity in the reporting of periodic information that is needed for effective supervision and other public policy purposes.
Information Sharing	Promotes the sharing of electronic information among the FFIEC agencies in support of supervision, regulation, and deposit insurance responsibilities of financial institution regulators. The task force provides a forum for FFIEC members to discuss and address issues affecting the quality, consistency, efficiency, and security of interagency information sharing. Significant matters are referred, with recommendations, to the Council for action, and the task force has delegated authority to take certain actions. To the extent possible, the agencies build on each other's information databases to minimize duplication of effort and promote consistency.
Surveillance Systems	Oversees the development and implementation of uniform interagency surveillance and monitoring systems and discusses best practices to be used in those systems and to consider the development of new financial analysis tools. The principal objective is to develop and produce the Uniform Bank Performance Report presenting financial data and peer group statistics on financial institutions. These reports are important tools for completing supervisory evaluations of a financial institution's condition and performance, as well as for planning onsite examinations. The banking agencies use the data from these reports to identify potential or emerging problems in insured banks.
Consumer Compliance	Promotes policy coordination, a common supervisory approach, and uniform enforcement of consumer protection laws and regulations. The task force identifies and analyzes emerging consumer compliance issues and develops proposed policies and procedures to foster consistency among the agencies. Additionally, the task force reviews legislation, regulations, and policies at the state and federal level that may have a bearing on the compliance responsibilities of the member agencies.

Source: FFIEC *2011 Annual Report*.

Glossary of Terms

Term	Definition
Administrative Law Judge (ALJ)	In 1989, FIRREA directed the federal banking agencies to establish a pool of ALJs to conduct hearings. In 1991, OFIA was created as the executive body responsible for processing administrative enforcement proceedings brought by the FDIC, OCC, FRB, or NCUA. The OFIA ALJ, an independent judicial officer, conducts hearings and rules on allegations of banking law violations initiated by one of the four federal banking agencies.
Bank Board Resolution (BBR)	A BBR is an informal commitment adopted by a financial institution's BOD (often at the request of the FDIC), directing the institution's personnel to take corrective action regarding specific noted deficiencies. A BBR may also be used as a tool to strengthen and monitor the institution's progress with regard to a particular component rating or activity.
Bank Secrecy Act of 1970 (BSA)	Codified at 31 USC 5311-5330, it gives the Department of the Treasury broad powers to implement AML regulations for financial institutions. Such regulations are implemented by the Department of the Treasury through 31 CFR Part 103. The Act consists of two Titles: Title I, Financial Recordkeeping, and Title II, Reports of Currency and Foreign Transactions. Title I authorizes the Department of the Treasury to issue regulations requiring insured financial institutions to maintain certain records related to financial transactions. Title II directs the Department of the Treasury to prescribe regulations governing the reporting of certain transactions by and through financial institutions in excess of $10,000 into, out of, and within the United States.
CAMELS	Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym. The six component areas are known as the CAMELS rating system (**C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to market risk). Evaluations of CAMELS components consider the institution's size and sophistication, the nature and complexity of its activities, and its risk profile. At risk management examinations, an institution is rated for each of the CAMELS components and assigned a composite rating, which generally bears a close relationship to the component ratings. The component and composite ratings are scored on a scale of 1 (best) to 5 (worst).
Case Manager	Case managers are responsible for assisting in the identification of risk and supervision for a caseload of banks assigned to them. The Case Manager program helps to (1) enhance risk assessment and supervision activities by assigning responsibility and accountability for a caseload of institutions or companies to one individual, regardless of charter and location, and by encouraging a more proactive, but non-intrusive, coordinated supervisory approach; (2) promote better communication and coordination between the FDIC, other regulators, and the banking industry; and (3) ensure that the

Glossary of Terms

Term	Definition
	level of regulatory oversight applied to an institution is commensurate with the level of risk it poses to the DIF.
Cease and Desist Order	A cease and desist order is a formal enforcement action issued by a financial institution regulator to a bank or affiliated party to stop an unsafe or unsound practice or a violation of laws and regulations. A cease and desist order may be terminated under certain circumstances, including when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.
Civil Money Penalties (CMP)	CMPs can be imposed on financial institutions for violations of: final and temporary orders, written agreements with the FDIC, laws and regulations, and breaches of fiduciary duty. The Financial Institutions Regulatory and Interest Rate Control Act of 1978 granted the FDIC authority to levy CMPs against both insured financial institutions and individuals for violations of statutes. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 broadened the scope of conduct for which CMPs can be assessed and significantly increased the amount of the permissible penalties.
Conference of State Bank Supervisors (CSBS)	CSBS works to: • optimize the authority of individual states to determine the activities of their financial institutions; • enhance the professionalism of state banking departments and their personnel; • represent the interests of the state banking system to federal and state legislative and regulatory agencies; and • ensure that all banks continue to have the choice and flexibility of the state charter in the new era of financial modernization.
FDIC Supervision Program	The FDIC's supervision program promotes the safety and soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised institutions. The FDIC's: • RMS (1) performs risk management examinations of FDIC-supervised institutions to assess their overall financial condition, management policies and practices (including internal control systems), and compliance with applicable laws and regulations; (2) issues related guidance to institutions and examiners; and (3) conducts specialty examinations, which are usually conducted during risk management examinations and include coverage of trust departments, information technology, and institution compliance with the BSA.

Glossary of Terms

Term	Definition
	• DCP conducts examinations to assess an institution's compliance with consumer protection statutes and regulations for all state nonmember banks that are not subject to the primary jurisdiction of the Consumer Financial Protection Bureau (CFPB). As part of the compliance examination process, the FDIC reviews substantive compliance issues as well as the accuracy and completeness of information and disclosures that institutions provide to consumers. The FDIC also conducts CRA performance evaluations for all state nonmember banks.
Federal Financial Institutions Examination Council (FFIEC)	The FFIEC is a formal interagency body empowered to: (1) prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the FRB, FDIC, NCUA, OCC, and CFPB; and (2) make recommendations to promote uniformity in the supervision of financial institutions.
Guidelines for Appeals of Material Supervisory Determinations (Guidelines for Appeals)	As required by Section 309(a) of the Riegle Act (Public Law No. 103-325, 108 Stat. 2160), the FDIC is required to establish an independent intra-agency appellate process to review material supervisory determinations made at insured depository institutions that it supervises. The Guidelines for Appeals describe the types of determinations that are eligible for review and the process by which appeals will be considered and decided. The procedures set forth in these guidelines establish an appeals process for the review of material supervisory determinations by the SARC.
Material Supervisory Determinations	As outlined in the FDIC's Guidelines for Appeals, material supervisory determinations may include, but are not limited to: ratings assigned by examiners, including CAMELS and compliance/CRA ratings; conclusions regarding the adequacy of the bank's allowance for loan and lease losses; and other supervisory determinations that may impact the bank's capital, earnings, or capital category for PCA purposes, or otherwise affect the nature and level of supervisory oversight accorded an institution.
Memorandum of Understanding (MOU)	An MOU is an informal agreement between the institution and the FDIC, which is signed by both parties. The State Authority may also be party to the agreement. MOUs are designed to address and correct identified weaknesses in an institution's condition.
Problem Bank Memorandum	A problem financial institution is defined as any insured institution which has been assigned a composite rating of 4 or 5 by its primary federal regulator or by the FDIC. A problem bank memorandum documents the FDIC's concerns with an institution and the corrective action in place or to be implemented. While an institution assigned a composite rating of 3 is not usually considered to be a problem institution, a problem bank memorandum is required on larger institutions assigned a composite rating

Glossary of Terms

Term	Definition
	of 3 as a means to document the FDIC's concerns and plans, due to the potential risk to the DIF. The problem bank memorandum is also used to effect interim rating changes in the FDIC's systems.
Prompt Corrective Action (PCA)	The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term cost to the DIF. Part 325, subpart B, of the FDIC Rules and Regulations, 12 CFR section 325.101, et. seq., implements section 38, *Prompt Corrective Action*, of the FDI Act, 12 USC section 1831(o), by establishing a framework for determining capital adequacy and taking supervisory actions against depository institutions that are in an unsafe or unsound condition. The following terms are used to describe capital adequacy: (1) *Well Capitalized*, (2) *Adequately Capitalized*, (3) *Undercapitalized*, (4) *Significantly Undercapitalized*, and (5) *Critically Undercapitalized*. A PCA Directive is a formal enforcement action seeking corrective action or compliance with the PCA statute with respect to an institution that falls within any of the three categories of undercapitalized institutions.
Supervision Appeals Review Committee (SARC)	Section 309(a) of the Riegle Act (Public Law No. 103-325, 108 Stat. 2160), required the FDIC to establish an independent intra-agency appellate process to review material supervisory determinations made at insured depository institutions that it supervises. In addition, the Riegle Act requires the FDIC to hear and decide appeals in an expeditious manner and protect appellants from retaliation by agency examiners.
Uniform Financial Institutions Rating System (UFIRS)	Refer to the definition for CAMELS.
Uniform Interagency Consumer Compliance Rating System	For compliance/CRA examinations, financial institution regulators and examiners use the Uniform Interagency Consumer Compliance Rating System (Rating System) approved by the FFIEC. Under the uniform rating system, each financial institution is assigned a consumer compliance rating predicated upon an evaluation of the nature and extent of its present compliance with consumer protection and civil rights statutes and regulations and the adequacy of its operating systems designed to ensure compliance on a continuing basis. The rating system is based upon a scale of 1 through 5 in increasing order of supervisory concern.

Appendix 8

Acronyms

Acronym	Explanation
ALJ	Administrative Law Judge
AML	Anti-Money Laundering
BBR	Bank Board Resolution
BOD	Board of Directors
BSA	Bank Secrecy Act
CAMELS	**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to Market Risk
CFPB	Consumer Financial Protection Bureau
CMP	Civil Money Penalty
CRA	Community Reinvestment Act
CSBS	Conference of State Bank Supervisors
DCP	Division of Depositor and Consumer Protection
DIF	Deposit Insurance Fund
DIR	Division of Insurance and Research
DSC	Division of Supervision and Consumer Protection
ED	Examination Documentation
EIC	Examiner-in-Charge
FDI	Federal Deposit Insurance
FFIEC	Federal Financial Institutions Examination Council
FIAP	Formal and Informal Action Procedures
FIL	Financial Institution Letter
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
FRB	Board of Governors of the Federal Reserve System
ICRS	Internal Control and Review Section
MOU	Memorandum of Understanding
NCUA	National Credit Union Administration
OATS	Ombudsman Automated Tracking System
OCC	Office of the Comptroller of the Currency
OCFI	Office of Complex Financial Institutions
OFAC	Office of Foreign Assets Control
OFIA	Office of Financial Institution Adjudication
OIG	Office of Inspector General
OJT	On-the-Job Training
OLA	Office of Legislative Affairs
OO	Office of the Ombudsman
PCA	Prompt Corrective Action
RD	Regional Directors
RMS	Division of Risk Management Supervision
ROE	Report of Examination
SARC	Supervision Appeals Review Committee
SBC	Senate Committee on Banking, Housing, and Urban Affairs
SLC	State Liaison Committee
UFIRS	Uniform Financial Institutions Rating System
ViSION	Virtual Supervisory Information on the Net

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August 29, 2012

Jon T. Rymer
Inspector General
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3501 Fairfax Drive, Arlington, VA
Arlington, VA 22226

Re: Response to Draft Audit Report Entitled *The FDIC's Examination Process for Small Community Banks (2012-041)*

Dear Mr. Rymer:

The FDIC has reviewed the Inspector General's (IG) draft report entitled, "The FDIC's Examination Process for Small Community Banks" (Draft Report). We appreciate the Draft Report's thoroughness and the opportunity to comment on its findings. The Draft Report acknowledges that the FDIC has implemented a nationwide program for planning, conducting, reporting and evaluating the effectiveness of our examination of FDIC-supervised community institutions and contains no recommendations for improvement in any of the areas under review.

We concur that the examination cycle and report processing timeframes increased as a result of the deteriorating condition of examined institutions and the complexity associated with an increasing number of troubled institutions. In this respect, the Draft Report recognizes that the FDIC's processes and controls continued to evolve during this time. It also notes the FDIC's longstanding quality control practices that promote consistency in the examination process and encourage examiners and bankers to make good-faith attempts to resolve disputes through informal discussions during examinations.

With respect to the formal dispute resolution process, the Draft Report confirmed the FDIC's analysis that the 2007-2009 financial crisis and related CAMELS rating changes were largely responsible for a number of formal reviews and appeals not being processed within the agency's self-imposed timeframes. The FDIC Board of Directors approved changes to the decisional deadlines in early 2010 that rectified these types of delays. These changes have enabled formal review and appeals to be analyzed and processed within more realistic timeframes. Since being implemented, the new decisional deadlines have been met with only one minor exception.

Finally, the Draft Report recognizes the various initiatives the FDIC has undertaken to further its dialogue with community banks, including the establishment of the FDIC's Advisory Committee on Community Banking, as well as other steps the agency has undertaken to ensure important community banking-related issues are identified, discussed and addressed. In addition, the Draft Report notes the FDIC is also developing guidance to assist community banks and smaller institutions understand and appropriately implement new and revised rules and regulations.

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The FDIC believes these efforts ensure the accuracy and fairness of the examination program and related dispute resolution processes for individual institutions, as well as the consistent treatment and application of examination procedures among all FDIC-supervised institutions. As such, we are pleased your Draft Report affirms FDIC's ongoing commitment to maintain a dynamic and responsive examination process as well as prudent and safe and sound banking standards.

Thank you for the opportunity to review the Draft Report.

Sincerely,

/signed/

Sandra L. Thompson
Director
Division of Risk Management Supervision