Division of Bank Supervision

# MEMORANDUM SYSTEM

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TO: Regional Directors

FROM: Paul G. Fritts
Director

SUBJECT: Policy for Examination Priorities and Frequency

1. Purpose. To set forth DBS policies for examination priorities and frequency and to define those areas where Regional Director discretion is allowed.

2. Background. The FDIC examination program is designed to help maintain public confidence in the integrity of the banking system, monitor compliance with applicable laws and regulations, protect the insurance fund and establish a factual record to support recommendations for corrective actions. Examinations are the crux of the risk identification process. However, the process of identifying and controlling risk on both an individual bank and industrywide basis has become more difficult as additional powers are granted and banks expand into a wide range of new activities. The Division believes deregulation of the industry must be balanced with a more intense supervisory program. This memorandum revises current policy to require more frequent onsite examinations for all insured State nonmember banks while continuing to give priority to all insured institutions requiring special supervisory attention and to those institutions presenting the most risk to the insurance fund and the industry.

3. Examination Intervals -- Safety and Soundness Examinations. The standard safety and soundness examination intervals for insured State nonmember banks are set forth below. Subsection "a" details the criteria to be used for extending the examination intervals. The CAEL monitoring system should be used with information obtained from State examinations, visitations, offsite reviews and other sources to establish examination priorities especially for those institutions with extended intervals. Although this memorandum sets forth maximum intervals for examinations and certain visitations, Regional Directors are encouraged to perform additional examinations or visitations whenever necessary.

| Composite Rating | Maximum Interval (Months) |
|---|---|
| 1 | 24 |
| 2 | 24 |
| 3 | 12 |
| 4 | 12 |
| 5 | 12 |

a. Extended Intervals. Intervals for 1- and 2-rated institutions may be extended up to 48 months and intervals for 3-rated institutions may be extended up to 24 months when: (1) an interim State examination that meets FDIC needs has been performed, and (2) the "CAELDIFF" score of the CAEL monitoring system confirms the rating. There should be no more than 24 months between the State examination and an FDIC examination for 1- and 2-rated institutions, and no more than 12 months between the State examination and an FDIC examination for 3-rated institutions.

b. Offsite Reviews. Offsite reviews should be conducted in accordance with outstanding instructions.

c. Visitations. Except as noted under "Other Situations," the Regional Director (or designee) has discretion to conduct visitations as necessary to: (1) monitor compliance with a formal corrective order or an informal agreement; (2) comply with CAEL followup requirements and to investigate other adverse or unusual situations; (3) determine progress in correcting deficiencies noted at the previous examination; (4) act as an effective investigative and supervisory tool as deemed necessary; and (5) comply with frequency schedules described under "Other Situations" listed below. While a visitation is not a substitute for an examination, it may be expanded into an examination when deemed necessary.

d. Other Situations. In addition to the preceding instructions, examinations or visitations should be performed in the following situations:

(i) Newly chartered and insured institutions:

- Visitations should be conducted within the first three and six months of operation. An examination is to be conducted within the first 12 months of operation. Subsequent to the first examination and through the third year of operation, at least one visitation is to be performed in each 12-month period during which an examination is not conducted.

- State examinations that meet FDIC needs can be substituted for the required FDIC examinations or visitations outlined in this subsection subsequent to the initial visitations and examination.

(ii) Institutions converting to insured nonmember status, including national, State member, thrift and industrial bank conversions:

- For national and State member banks converting to insured nonmember status, a visitation should be conducted within the first six months after the conversion. An examination is to be conducted within 24 months of the last examination prior to conversion if the institution was assigned a rating of 1 or 2 and the rating is confirmed by CAEL. An examination is to be conducted within 12 months of the last examination prior to conversion if a 3-, 4- or 5-rating was assigned or indicated by CAEL or to investigate other adverse or unusual situations.

- For thrift and industrial bank conversions, a visitation should be conducted within the first six months after the conversion. An examination is to be conducted within 24 months of the entrance examination if the institution was assigned a rating of 1 or 2. An examination is to be conducted within 12 months of the entrance examination if a 3, 4 or 5 rating was assigned.

- Thrift institutions and industrial banks that have not had an FDIC entrance examination prior to the conversion should have a visitation within three months after the conversion and an FDIC examination within 12 months after the conversion.

(iii) Institutions which have had a change of ownership control:

- If the Regional Director's knowledge of the new ownership reflects a satisfactory financial and management performance record, standard examination intervals apply. If new ownership is unknown, at least one visitation is to be conducted within the first three months after the change of ownership control and an examination is to be conducted within the first 12 months after the change. Subsequent to the first examination and through the third year from the change, at least one visitation is to be performed in each 12-month period during which an examination is not conducted.

- Subsequent to the initial visitation and the first examination, State examinations that meet FDIC needs can be substituted for the FDIC examinations or visitations required in this subparagraph.

(iv) Insured institutions that have received FDIC assistance or been involved in purchase and assumption or deposit transfer transactions:

- Acquiring institutions with total assets in excess of ten times the deposits acquired, which are rated composite 2 or better, and have an acceptable CAELDIFF score are exempt from the following requirements, including any reporting. Aside from the initial visitation, the requirements outlined in this paragraph are part of the ongoing supervisory process. Procedures directly related to compliance with assistance agreements will be described separately.

- If the institution is a State nonmember, a visitation is to be conducted within 30 days of the date of the transaction to determine how funds from the FDIC are being used and whether the bank is in accordance with the assistance agreement, if there is one. A second visitation is to be conducted within six months of the transaction. A third visitation should be conducted within the second 12-month period after the transaction.

- If the institution is a State nonmember, an examination is to be conducted within the first 12 months of the transaction. Thereafter, the standard examination frequency schedule applies.

- For national and State members, a cooperative program should be established with the other Federal supervisory agencies to ensure that all institutions receiving FDIC funds are properly monitored. The primary Federal supervisor has responsibility for the oversight of the institution and should be requested to keep the FDIC Regional Director informed of important developments. The Regional Director has discretion to determine the extent of direct FDIC involvement in this process.

° The Regional Office is to submit to the Associate Director, Supervision, Enforcement and Surveillance Branch, a quarterly report that includes: (a) a listing of each assisted or assuming bank including State member and national banks; (b) a brief description of the bank's condition including the uniform bank rating; (c) the CAEL rating and CAELDIFF score; and (d) the Region's supervisory plan for each bank including the oversight performed by other Federal agencies. Banks should remain on the list for two years. Any deviation to the examination or visitation schedule outlined in this subsection should be explained in this quarterly report.

4. Coordination with State Authorities. Every effort should be made to coordinate examination and visitation schedules of all FDIC supervised institutions with State authorities to take advantage of State authority resources and to minimize duplication of effort and burden on the institutions. Toward the end of the year, the Regional Director (or designee) should meet with representatives from each State banking authority to determine relative examination responsibilities for the upcoming calendar year. This may be done in broad categories by rating, size and location of institution or it may be done by specific institution as deemed appropriate. Such agreements should remain informal, with enough flexibility to allow either party to alter schedules with minimal notice.

The agreement should strive to provide for a safety and soundness examination and, where appropriate, specialty area examinations of all insured State nonmember banks within intervals (including allowable extensions) not less frequent than those prescribed in this memorandum. While State law examination requirements should be considered in the negotiation process together with other appropriate factors, such statutory requirements should not be the determining factor in the final agreement.

5. Coordination with Other Federal Agencies of Bank Holding Company Inspections and Subsidiary Institution Examinations. Federal bank regulatory agencies have agreed to conduct coordinated bank holding company inspections and lead bank examinations for: (a) any bank holding company with consolidated assets in excess of $10 billion; (b) any bank holding company or its subsidiary lead bank rated composite 4 or 5 under the bank holding company rating system or the uniform rating system for banks; and (c) any bank holding company or its subsidiary lead bank rated composite 3 whose financial condition appears to have worsened significantly since the last inspection or examination. In multibank holding companies without a designated lead bank, the largest bank in total assets generally should be considered the lead bank. However, when other banks in a holding company are similar in size or larger than the designated lead bank, the condition and general performance trends of those banks together with the lead bank should be an important factor in establishing examination

priorities. Whenever possible, examinations and inspections are also to be coordinated for all other bank holding companies.

Bank examinations for subsidiary banks within a multibank holding company should be coordinated with the parent inspection to the extent practicable and where resources will permit. Regional Directors (or designee) should meet at least annually with their counterparts from other Federal agencies in order to develop a coordinated schedule that will maximize the efficient use of examination resources and enhance the integration of bank and bank holding company examinations. The appropriate State bank regulator should be kept informed and encouraged to participate in the coordinated Federal efforts affecting State banks. Coordination of inspections and examinations should focus on the use of common financial statement dates where possible, and allow for joint discussions of examination findings with management. Absolute concurrency, common "as of" dates or simultaneous starting dates are not required.

Examinations of nonbank affiliates may be conducted at the discretion of the Regional Director, but independent examinations of holding companies supervised by the Federal Reserve may not be conducted without prior approval of the Washington Office.

6. <u>Supervision of Interstate Banking Organizations and Chain Banks</u>. In addition to the guidelines outlined in paragraph No. 5 above, a coordinated supervisory strategy for interstate banking organizations (both inter- or intraregional) should be developed. Regional Directors are responsible for designating a lead Region to design an appropriate supervisory strategy for those organizations and to ensure pertinent information is conveyed in a timely manner to other DBS Regions and to appropriate Federal and State regulators.

The supervisory strategy developed by the lead Region should combine traditional supervision of individual units with an appropriate top-down approach to assess risk and monitor and coordinate supervisory actions. For these organizations, the Regional Director has discretion to omit, delay or modify existing examination frequency policy if: (1) the financial condition of the holding company and lead bank is considered satisfactory; (2) the condition of the subsidiary units is believed to be satisfactory; (3) control over all insured banks in the organization is effectively centralized; and (4) management is favorably regarded. Refer to Regional Director Memorandums related to supervision of interstate banking organizations, Classification No. 6610, for further guidance in this area.

It is the policy of the Division to monitor and supervise banks that are part of a chain banking organization in a manner that fully considers the financial impact of the consolidated chain on the individual institutions within that chain. Regional Directors have been assigned responsibility for maintaining a record system for chain banking organizations and for developing an overall supervisory strategy for those organizations. This involves interregional planning sessions to: (1) evaluate examination priorities; (2) assign Regional responsibility; (3) develop examination strategies; and (4) coordinate the process with other supervisory authorities, as appropriate. Refer to Regional Director Memorandums related to chain banks under Classification No. 6800 for more specific guidance in this area.

7. Examinations of National Banks, State Member Banks and Federal Savings Banks. Regional Directors may use their discretion in planning examinations of State member, national and Federal savings banks. Examinations of State member banks where an FDIC presence is deemed appropriate will be subject to approval by the Director of DBS under existing guidelines. Examinations of Federal savings banks should be performed in accordance with the cooperative examination program that became effective in July 1984. Examinations of multinational national banks are to be decided on a case-by-case basis by the OCC's Senior Deputy Comptroller for Supervision and the FDIC's Director of the Division of Bank Supervision. Examinations of all other national banks, including large regional institutions are to be determined at the Regional Office level. Factors to be considered when establishing priorities for State member and national bank examinations include risk to the insurance fund; evidence of serious deterioration which may require corrective action; and whether financial assistance had been granted to the institution. Consideration should also be given to examining or participating in examinations of large well-rated institutions as an effective way to gain valuable experience in the large bank environment and in more specialized areas of banking.

8. Entry of FDIC, State and Other Federal Agency Examinations onto the FDIC Database. The Regional Office is responsible for the timely entry of FDIC, State and other Federal agency examination data to the online database. FDIC examination data should be entered as soon as possible after the report is received in the Regional Office. Procedures should also be in place to ensure that State and other Federal agency reports are received within a reasonable time period and that the reports are reviewed and the database updated within 60 days of receipt. With regard to OCC examinations, the Regional Office should have access (either in hard copy or through the OCC's online SMS) to enough information to conduct a proper review. This is necessary to ensure that current examination data are available for offsite monitoring, bid list preparation and a variety of management reports. State examination reports dated after August 1, 1988, that are usable to extend examination intervals should be coded "A" on the examination system. Other State examinations, if useful for information purposes, should be entered and coded "B." Examinations coded "B" will not be used by CAEL. All reports from a given State need not be coded the same way; some can be coded "A" and some "B." Generally, those coded "A" should relate to the agreed upon examination schedule described in paragraph 4.

A Summary Analysis of Examination Report (Form 96) should be prepared for each OCC and Federal Reserve examination report which is reviewed. If all the information necessary to complete the form is not available from the examination report data, the database or discussion with the regulator, the information that is available should be entered. A type code of "N" and a scope of "X" should continue to be used for these examinations. When these codes are used the only items required are the CAMEL rating components and the composite rating together with the examiner-in-charge and date of examination. Additional items such as assets, deposits or classifications may be entered as available.

Since only ten examination events can be retained on the online database at one time, procedures should be established to ensure that the last full-scope or most complete examination performed by the OCC and Federal Reserve is retained if it is still considered relevant. Other limited-scope examinations or events should be dropped from the database to permit entry of the most current examination.

9. Examination Intervals - Specialty Examinations. Specialty examinations generally should be conducted concurrently with safety and soundness examinations except when the size or arrangement of the department makes it impractical or inefficient to do so. However, when the safety and soundness rating is a 1, 2 or 3 and the specialty area is rated 4 or 5, a specialty examination is to be conducted within a 12-month interval. Conversely, if the safety and soundness rating is 3, 4 or 5, the specialty examination may be extended to the maximum interval if the specialty area is assigned a rating of 1, 2 or 3.

Only the Trust and Data Processing areas are eligible for extra extended examination intervals based on State examinations. The criteria for extending examination intervals in these areas are explained in the appropriate subsection below. Other areas must conform to the standard examination intervals listed below even when the safety and soundness examination has been extended.

| Specialty Composite Rating | Maximum Interval (Months) |
|---|---|
| 1 | 24 |
| 2 | 24 |
| 3 | 24 |
| 4 | 12 |
| 5 | 12 |

a. Bank Secrecy Act ("BSA") Compliance Examination. The FDIC is required by statute to review compliance with the Treasury Department's currency reporting regulations (31 CFR 103) and FDIC Section 326.8 at each examination of the bank. Accordingly, concurrent BSA reviews should be conducted with each safety and soundness or compliance examination (but not more than once per annum). Where a compliance examination is conducted concurrently with the safety and soundness examination, BSA reviews should be included in the compliance report. A separate BSA review should be prepared when no compliance examination is conducted with the safety and soundness examination. When the safety and soundness examination period has been extended, a BSA review should be done with any interim compliance examination.

b. Compliance. Examinations generally should be conducted concurrently with safety and soundness examinations in accordance with prescribed intervals. Additional examinations or visitations are encouraged as deemed necessary by the Regional Director.

c. Data Processing Facilities. Examinations of data processing facilities operated by an FDIC supervised institution or its subsidiary generally should be conducted concurrently with safety and soundness examinations, in accordance with prescribed intervals. In those cases where the size or arrangement of the data facility makes this inefficient or impracticable, separate examinations may be conducted. Regional Directors have discretion to extend examination intervals for 1-, 2- and 3-rated data processing facilities up to 48 months if there has been an interim State examination that meets FDIC needs since the last FDIC examination. There should be no more than 24 months between the State examination and an FDIC examination for 1-, 2- and 3-rated data facilities. Additional examinations or visitations are encouraged when considered necessary by the Regional Director.

Independent data processing facilities are subject to the same examination frequency policy as financial institutions. Regional Directors should coordinate with other responsible Federal agencies for joint or rotated examinations of data facilities operated independently or by a holding company, or its affiliate, which service both FDIC supervised institutions and other intitutions. FDIC participation is encouraged for examinations of national and State member institution data facilities, or their affiliated organizations, which provide services for FDIC supervised institutions.

Examinations of data facilities subject to the Multiregional Data Processing Servicer (MDPS) program will be scheduled at the Washington Office level by the FFIEC's EDP Examination Task Force Subcommittee.

d. Government Securities Dealer and Broker Activity. The Department of Treasury has not issued regulations requiring specific examination frequencies for examinations of Government securities brokers and dealers. Nevertheless, for efficiency, when a bank is both a municipal securities dealer and a Government securities dealer or broker, the examinations of both departments should be conducted concurrently in accordance with prescribed intervals for specialty examinations. A bank which is a Government securities broker or dealer, but not a municipal securities dealer, also should be examined in accordance with prescribed intervals. These examinations generally should be performed concurrently with other types of examinations but may be conducted independently as appropriate. Additional examinations or visitations are encouraged when deemed necessary by the Regional Director.

e. Municipal Securities Dealer Activity. The Municipal Securities Rulemaking Board Rule G-16 requires that an examination of the municipal securities dealer activities of institutions which are registered with the SEC as municipal securities dealers is to be conducted at least once every 24 months. These examinations generally should be performed concurrently with other types of examinations but may be conducted independently as appropriate. Additional examinations or visitations are encouraged when deemed necessary by the Regional Director.

f. Transfer Agent. Examinations generally should be conducted concurrently with safety and soundness examinations or with independent trust examinations, as appropriate, in accordance with prescribed intervals. If an institution is subject to the transfer agent registration requirements of Part 341 and also has a trust department, the transfer agent function should be examined at all trust department examinations. If the institution does not have a trust department but is subject to Part 341, the transfer agent examinations should be performed with the safety and soundness examination. Additional examinations or visitations are encouraged when deemed necessary by the Regional Director.

g. Trust. Examinations generally should be conducted concurrently with safety and soundness examinations in accordance with prescribed intervals. Separate examinations of larger departments may be conducted when deemed necessary by the Regional Director. Regional Directors have discretion to extend examination intervals for 1-, 2- and 3-rated trust departments up to 48 months if there has been a State examination that meets FDIC needs since the last FDIC examination. There should be no more than 24 months between the State examination and an FDIC examination for 1-, 2- and 3-rated trust departments.

10. Insured Branches of Foreign Banks. The same priorities and frequency of examinations including instructions regarding visitations and other situations described in this memorandum that are applicable to domestic FDIC supervised institutions are applicable to insured branches of foreign banks.

11. Responsibility and Action. Regional Directors should strive to provide for a safety and soundness examination and specialty area examinations of all State nonmember banks within the prescribed intervals (including allowable extensions). Consideration also should be given to the number of State member, national and Federal savings banks that may require FDIC examinations or participation by the FDIC. An estimate showing the number of safety and soundness as well as specialty area examinations by State for the coming year should be submitted to the Director of Division of Bank Supervision no later than January 31 of each year. This projection should be made after discussions and agreements have been made with State and Federal authorities regarding examination responsibilities for the next calendar year. A June 30 progress report should be submitted to the Director of the Division of Bank Supervision no later than July 31. Significant variances from projections or changes in future projections should be discussed in this report.

Full implementation of this examination program will depend on the personnel resources available as well as the general structure and condition of the industry. Because of differences in staffing and overall banking conditions in each Region, implementation periods will vary. However, Regional Directors should request authorization to hire sufficient staff and should develop necessary operating procedures to be in full compliance with this program within a reasonable time period.

When the examination frequency requirements outlined in this memorandum cannot be met because of personnel restrictions or other reasons, a description of the nature and cause of the situation, necessary corrective measures planned, implemented or needed and interim steps being taken to maintain an adequate supervision program should be included with the examination projections due on January 31. An updated discussion should be included with the June 30 progress report. A discussion addressing the general situation existing within the region is acceptable in lieu of a notification for each institution for which examination requirements cannot be met. However, for a bank rated 4 or 5 which is not examined within 12 months, an explanatory memorandum to the files should be prepared.

12. Effective Date. This policy is effective immediately. Regional Director Memorandums: Priorities, Frequency and Scope of Examinations, May 14, 1985, Classification No. 6610, Transmittal No. 89, Supervision of Banks Having Received FDIC Assistance, March 29, 1988, Classification No. 6610, Transmittal No. 88-044, and Timely Updates to the Online "96" Database, June 13, 1986, Classification No. 6610, Transmittal No. 86-112, are hereby rescinded.