- ATTACHMENT #1

Division of Bank Supervision

MEMORANDUM SYSTEM

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MEMORANDUM TO: Regional Directors

FROM: Paul G. Fritts
Director

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SUBJECT: Anticipatory Supervision and Guidelines for Scheduling Safety and Soundness Examinations of Banks Rated 1 and 2

1. Purpose. To summarize existing practices and provide additional guidance on supervision of 1 and 2 rated banks. See Section 3, Examination Intervals -- Saftey and Soundness Examinations in the Policy for Examination Priorities and Frequency (7-29-88, #88-106.).

2. Background. The FDIC's study of the deposit insurance system -- Deposit Insurance for the Nineties, emphasizes the need for supervision to be more anticipatory in nature. One of the recommendations for improved supervision is for regulatory agencies to develop improved methods for identifying risk, setting priorities and allocating resources effectively.

It is important that we continue our effort to reduce the historical emphasis on periodic examinations based largely on the passage of time, in favor of more frequent and less structured supervision based on our best reading of potential risk in an institution. Investigations, phone calls, visitations, correspondence, and other forms of customized contact with banks, in order to identify potential problems and take preventative action, should have increasing priority for our limited resources. This, however, should not be taken as an attempt to diminish the importance of periodic full scope examinations. These remain critical to our supervisory process and an integral part of our policy on examination priorities.

As our priorities continue to shift somewhat in determining what form of supervision is most appropriate in a given situation, so must the focus of that supervision shift as well. Increased emphasis must be placed on the management process without reducing traditional concern with a bank's financial condition. The intent should be to identify and obtain corrections of weaknesses in a bank's policies and procedures that have a realistic potential to cause financial problems before the adverse financial condition occurs.

The success of this effort depends largely on the effectiveness of the Field Office Supervisor or other person scheduling work. Examiner resources should be allocated and directed based on the best information available as to potential problems and without over emphasizing the mere passage of time. This has always been true but is even more important in these times of increased demands on examiner resources, greater volatility in performance and condition being experienced by the banking industry, and increased opportunities for banks to incur risk.

Because of this increased importance, and as an aid to new Field Office Supervisors or others involved in examination scheduling and as a reminder to the more experienced personnel, this memorandum will discuss some of the factors and thought processes that should be considered when allocating examiner resources to the supervision of 1 and 2 rated institutions.

3. Anticipatory Supervision. If we are to be effective in preventing problems, we must emphasize the processes of a bank as well as its condition. If improved scheduling allows us to find weaknesses before they become significant problems, we need not wait until the condition of the bank actually deteriorates before we take corrective action. We must be willing to make our concerns forcefully known to bank management and work for necessary corrective measures. Moral suasion and informal agreements normally will be sufficient but we must be prepared to consider formal action before the bank is rated worse than 1 or 2 if circumstances warrant.

A prospective supervisory approach, entailing criticism of policies and practices before the actual signs of an unsafe and unsound condition, calls for serious thought and careful comment by examiners. Critical comments must be well supported based on logic, prudent banking standards and practices, and the potential for harm. In questionable circumstances where formal action is considered a possibility, it is desirable to consult with the Regional Office while the examination is in progress regarding the material needed to support the potential action.

4. Scheduling Process. The Policy for Examination Priorities and Frequency establishes a maximum interval of 24 months between examinations of banks rated 1 or 2, with the ability to extend this interval to 48 months in certain circumstances. There is no required minimum time period between examinations. In fact the Policy encourages Regional Directors "to perform additional examinations and visitations whenever necessary".

A goal of examinations of 1 and 2 rated banks is to head off problems before they cause serious difficulties and become a financial risk to the FDIC. Therefore, it is far more important to examine, or otherwise supervise, a bank if there is some reason to suspect a problem than if the bank merely has not been examined for a specified time.

However, a formal examination may not be the most efficient use of resources in investigating the risk potential a bank may represent. The objective is to assess the problem and if necessary devise a solution in the quickest most efficient manner possible, given available resources. Frequently, a phone call or brief onsite visit will suffice. Sometimes such preliminary efforts will indicate that a full scope examination is appropriate.

In order for all available information to be considered when scheduling, it is critical that the Field Office Supervisor and other appropriate personnel be aware of and have access to it. Regional Directors should insure that copies of relevant correspondence or other information are made available. Procedures should be established to insure that information that may impact a scheduling decision is documentated and made available to scheduling personnel. Individuals doing scheduling must insure that this information is reviewed and considered in scheduling decisions. It is expected that success in this effort will be an important aspect of performance evaluation for the individual who performs scheduling.

Because of the variety of sources and forms of relevant information available, it is not possible to design a uniform system of information gathering and reporting. However, we have attached a list of some of the kinds of information that may come to our attention and have an influence in scheduling decisions. Some of these items, such as involvement in FDIC assistance transactions, have specific supervisory schedules specified in our Policy. Others are just information that, in and of itself, may or may not raise a concern depending on what else is known about the bank. However, these or similar items may give a signal that requires further follow-up. Such clues should not be ignored. The list is obviously not all inclusive, however, it indicates the thrust of the need for supervision to be more anticipatory and provide a reminder of some of the common sources of information that may warrant consideration when scheduling.

INFORMATION TO CONSIDER IN SCHEDULING EXAMINATIONS

Effective bank supervision entails the constant assimilation of information from numerous sources, both within and outside the FDIC. The appropriate response, if any, depends on the circumstances, supervisory action already underway, what is known about the institution and what can be learned from followup procedures. In some instances the information serves as a "red flag", leading to an immediate examination. In less severe situations, the information is retained and factored into the process of scheduling future visitations and examinations. It is possible that a given piece of information can be derived from more than one source. Thus, some of the items listed below are included in more than one of the categories.

- -Call reports
- -Applications, notices or other bank provided data
- -Known characteristics
- -Examination of other banks
- -Other bank regulators
- -Media
- -Rumors, observations, other

CALL REPORTS

Loss for year or interim period
Rapid growth in assets or deposits
Significant change in asset composition
Significant change in liability composition
CAEL Diff monitoring system
Use of brokered funds
Analysis of UBPR
Excessive dividends relative to earnings
Excessive bond trading
Other ratios or numbers that are unusual or have changed dramaticaly

APPLICATIONS, NOTICES OR OTHER BANK PROVIDED DATA

Change of control
Merger
Acquisition or establishment of a new subsidiary
Acquiring party in a FDIC arranged transaction
Change in external auditor
Exercise of a new power or a new profit center
Newly insured bank
Affiliation with a 3, 4, or 5 rated bank or holding company
Cancellation of blanket bond insurance
Large defalcation
Review of CPA audit reports
Large paydown or payoff of previously classified loans

KNOWN CHARACTERISTICS

Excessive salaries
Failure to pay competitive salaries
Compensation linked to future performance such as income, loan volume or deposit growth
Infighting involving senior bank officers and/or directors
Significant litigation against the bank or insiders
Operating at the margin of laws and regulations
Management believed to be less than trustworthy
Self-serving management
Dominating management
Inexperienced management
Substantial outside business interests of a key officer
Conducting business with questionable firms such as certain bond dealers

EXAMINATIONS OF OTHER BANKS

Hiring of a dismissed, unethical or marginal officer
Refinancing poor quality loans
Improper handling of correspondent bank account
Advertising above market interest rates
Undercutting on price and credit quality to increase market share of loans
Large blocks of bank stock pledged as collateral
Increased or unusual loan participations among affiliated or closely held banks
Banker with past due loans at another bank

OTHER BANK REGULATORS

Improper handling of correspondent bank accounts
Increased or unusual loan participations among affiliated or closely held banks
Large blocks of stock pledged as collateral
Affiliation with a 3, 4 or 5 rated bank or holding company
Large defalcation
Banker with past due loans at another bank
Hiring of a dismissed, unethical or marginal officer
Loans classified at other institutions

MEDIA

New chief executive officer or chief lending officer
Adverse publicity
Loss for the year or an interim period
Adverse economic event in the community
Natural disaster such as a flood, fire or earthquake
Large defalcation
Large financial commitment as sponsor or lead bank in a major project, or development
Banker death or disappearance
Announcement of major new activity or department

RUMORS/OBSERVATIONS/OTHER

Change in external auditor
High or sudden employee turnover
Significant litigation against the bank or insiders
Unusual activity in bank stock (price movement up or down or heavy trading volume)
Bank advertising above market rates
Significant change in the composition of assets or liabilities
Questionable loans being booked
Bank dealing with borrowers of questionable character
Confidential or anonymous tips