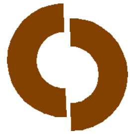

Comptroller of the Currency
Administrator of National Banks

Bank Supervision Process

Comptroller's Handbook

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EP

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Background

The OCC is responsible for promoting the safety and soundness of the national banking system and for ensuring that national banks provide services consistent with legal standards. To carry out this directive, the OCC's goal is to:

- Ensure safety and soundness of national banks.
- Promote competitiveness for national banks.
- Improve the efficiency of examinations and supervision, including reducing supervisory burden.
- Ensure fair and equal access to credit.

Philosophy

The OCC supervises all national banks according to a philosophy based on providing high-quality bank supervision directed at identifying material problems, or emerging problems, in individual banks or the banking system, and ensuring that such problems are appropriately corrected. Because banking is essentially a business of accepting risk, that philosophy is centered on evaluating risks. The OCC applies that philosophy in all supervisory activities, including safety and soundness, compliance, fiduciary, etc., that it conducts. (The policies and philosophy outlined in this booklet generally apply to the OCC’s supervision of federal branches and agencies. When exceptions to the supervision of these entities occur, they are specifically detailed in appropriate handbook booklets or OCC bulletins.)

At the OCC, high-quality bank supervision:

- Is a non-intrusive, cooperative process between bankers and examiners which adds value to the supervised institution.
- Is based on clear communication of the responsibilities of bankers and examiners.
- Is tailored to the characteristics of each bank, such as size, complexity, and risk profile.

- Ensures supervision is dynamic and responsive to changing risks at individual institutions and to evolving market conditions.

- Focuses on ensuring that banks have established and are following appropriate risk management systems.

- Does not substitute examiners' judgment for bankers' if the bank is:
  - Following sound fundamental principles.
  - Appropriately managing and controlling risk.
  - Taking action to correct problems.
  - Cooperative in correcting violations of law or regulation.

- Ensures banks comply with laws and regulation by focusing on substantive compliance and using testing to verify compliance.

- Uses OCC resources efficiently and effectively by allocating the greatest resources to those areas of highest risk.

The OCC sets a supervisory schedule for each bank based on the statutory requirement for periodic safety and soundness examinations, the OCC's policy for specialized examinations, and a consideration of the types, variety, and volume of risks a bank accepts. Supervision is much more than on-site examination of bank operations; it is a complex cycle of planning, examining, and communicating that involves cooperation between the supervisor, other regulators, and the institution being supervised. At every stage of that cycle, the OCC evaluates the effectiveness of the bank's management in identifying, measuring, controlling, and monitoring risks.

After presenting some basic definitions as background, this booklet explains the responsibilities of the participants in the supervisory process. That is followed by a discussion of the way OCC incorporates risk into its assessment of a bank. The booklet then discusses the OCC's supervision process, describing how examiners plan, examine, and communicate. The booklet concludes with a review of the internal processes at the OCC that help to ensure that it supervises banks in an effective and efficient manner.

Definitions

The explanations below provide the basic definitions that will be used in the OCC's discussions of bank supervision.

CAMEL Rating System

The OCC, like other bank regulatory agencies, uses the Uniform Financial Institutions Rating System, commonly called the CAMEL rating. This rating

system provides a general framework for assimilating and evaluating all significant financial operational and compliance factors inherent in a bank. It enables the supervisor to assign each banking organization a composite rating that indicates the institution's overall condition, including the condition of the specialty areas.

In order for examiners to reach a composite rating of a bank, evaluations are made on:

- **C**apital adequacy.
- **A**sset quality.
- **M**anagement.
- **E**arnings.
- **L**iquidity.

National bank examiners also evaluate the following specialty areas:

- **E**lectronic Data Processing.
- **T**rust.
- **C**onsumer Compliance.
- **C**ommunity Reinvestment.

Specialty ratings are added to the acronym CAMEL. For example, ratings for the specialty areas listed above appear as CAMEL/ETCC. (For a more specific description of CAMEL, refer to Examining Circular 159, Supplement 1, Uniform Interagency Rating System.)

Examination Cycle

An examination cycle is the immediate planning horizon for supervising a national bank. For scheduling purposes, an examination cycle begins on the **examination close date**, the date the examination activity is complete and ready for supervisory office review, and extends to the next **examination start date**, the date examiners begin work in the bank or begin reviewing data for the next examination. The cycle covers all planned supervisory activities that will commence during that time frame. An examination cycle is based on statutory requirements for frequency of examination and reflects the risk inherent in the bank. Changes in a bank's condition between on-site examinations may cause supervisors to change the timing of the next examination, but the examination cycle (12- or 18-month) should not be changed between examinations.

Full Scope, On-site Examination

A full scope, on-site examination is one that is sufficient in scope to assess the bank's composite and component CAMEL ratings and make a conclusion

about the bank's risk profile. Such examinations are also referred to as "statutory examinations" because they fulfill the requirements set by the Federal Deposit Insurance Improvement Act of 1991 (FDICIA, 12 U.S.C. 1820(d)). OCC examiners must perform at least some of the activity associated with such an examination on-site. A full scope, on-site examination generally concludes with the issuance of a uniform common core report of examination (ROE).

Targeted Examination

A targeted examination is any examination that does not fulfill all of the requirements of the statutory examination. The OCC sometimes combines several targeted examinations to accomplish the statutory requirement for a full scope, on-site examination. Targeted examinations may focus on one particular product, area, or risk (e.g., credit cards, or interest rate risk) or may cover specialty examinations (e.g., consumer compliance or fiduciary activities).

Examination Frequency and Scope

Safety and Soundness Examinations

Section 306 of the Riegle Community Development and Regulatory Improvement Act of 1994 (CDRI) amended Section 111 of FDICIA. These amendments and Section 111 establish requirements for the frequency of on-site safety and soundness examinations. **Every national bank must receive a full-scope, on-site examination not less than once every 12 months**. This requirement extends to all insured financial institutions, **including insured trust companies and bank subsidiaries of multibank holding companies**. The OCC may extend the 12-month interval to 18 months if all of the following criteria are met:

- Total assets were less than $250 million at the previous examination close date.
- The national bank is considered well-capitalized in accordance with FDICIA section 131, Prompt Corrective Action (12 U.S.C. 1831o; 12 CFR 6).
- The national bank is well-managed.
- The national bank's condition is:
  - Outstanding (composite CAMEL rating of 1); or
  - Outstanding or good condition (composite CAMEL rating of 1 or 2) and total assets are less than $100 million at the previous examination close date.

- The national bank is not subject to any formal enforcement action.

- No person acquired control of the institution during the 12-month period in which a full-scope, on-site examination would be required.

The statutory requirement sets a **maximum** amount of time between full scope examinations. If appropriate, OCC supervisory offices, however, have the discretion to schedule examinations more frequently. For example, the OCC may schedule more frequent examinations when potential or actual deterioration in a bank requires prompt OCC attention, when a change in control of the institution has taken place, or when there is a supervisory office scheduling conflict. Supervisory offices should consider the efficient use of OCC resources and the potential increased burden on the bank before increasing the frequency of the scheduled examination.

The scope of a safety and soundness examination is based on the principles of Supervision by Risk outlined in this booklet. The scope, however, must be sufficient to fulfill the statutory requirements of a full-scope, on-site examination and conclude on the risk profile.

Specialty Examinations

The OCC conducts specialized examinations for areas not directly related to fulfilling statutory requirements for safety and soundness examinations. The overall philosophy for conducting these examinations is based on the principles of Supervision by Risk outlined in this booklet, similar to safety and soundness examinations. The scope of each specialty area must be sufficient to assess the applicable composite and component ratings for the particular specialty. For Community Reinvestment Act (CRA) examinations, the scope must be sufficient to support the issuance of a CRA public opinion. Due to statutory requirements, consumer compliance examinations must also incorporate a review of bank compliance with the Flood Disaster Protection Act and the Bank Secrecy Act.

The frequency of these examinations is not set by statute. As explained below, the OCC has established a separate specialty cycle for frequency of examinations for each of the areas.

Consumer Compliance

Consumer compliance examinations encompass all consumer compliance areas, including the Bank Secrecy Act, CRA, and fair lending.

In **large** banks, consumer compliance examinations are conducted on a two-year cycle. In the past, the OCC performed **community bank** consumer

compliance examinations based on a random sample of banks each year. Between 1994 and year-end 1996, however, all community banks will receive a consumer compliance examination. Beginning in January 1997, consumer compliance examinations will occur every 24 or 36 months, based on the safety and soundness examination cycle described above. Community banks on a 12-month examination cycle will receive a compliance examination at least every 24 months. Community banks on an 18-month examination cycle will receive a compliance examination at least every 36 months. During the full-scope, on-site examination that occurs in the interval, examiners must at least follow up on concerns noted at the prior compliance examination. More frequent examinations of CRA may be required if the CRA rating is more than 24 months old and a formal protest from the public is received regarding a corporate application.

Bank Information Systems (BIS) Examinations

A BIS examination must be conducted at the same frequency as the on-site examination (i.e., once in each 12- or 18-month cycle). BIS examinations are normally conducted concurrently with other parts of the safety and soundness examination.

Independent data centers under the Multiregional Data Processing Servicers (MDPS) program will be examined on a 12-, 18-, or 24-month basis, based on ratings as described in the FFIEC guidelines (Examining Circular 261). In addition, interim reviews at a minimum of every 12 months are required (OCC Bulletin 95-5).

Interagency guidelines do not specify frequency requirements for non-MDPS data centers. These include independent servicers, bank service corporations, and holding company departments or subsidiaries. The OCC has determined that those centers will be examined every 12 months. The scope of the activity must be sufficient to verify the BIS ratings.

Federal Branch and Agency Examinations

FDICIA requires an annual on-site examination of federal branches and agencies. The examination scope must be sufficient to make a judgment on the accuracy of the applicable composite and component ratings outlined in the "Interagency Supervisory Rating System for U.S. Branches and Agencies of Foreign Banks." (See PPM 5130-1.)

Fiduciary Examinations

Fiduciary powers of national banks can legally occur in three separate ways: the OCC can approve fiduciary departments within the bank itself; the OCC

can charter separate insured trust companies; or the OCC can charter uninsured trust companies. The OCC's policy for examinations of each legal entity differs. Specifically,

- Fiduciary examinations of bank trust departments are conducted at least every 24 or 36 months, as determined by the safety and soundness examination cycle. For example, commercial banks that are on a 12-month safety and soundness examination cycle will receive a fiduciary examination at least every 24 months. Likewise, commercial banks on an 18-month safety and soundness examination cycle will receive a fiduciary examination at least every 36 months. The frequency of the fiduciary examination may be increased if the portfolio manager, with supervisory office approval, determines there is increased need for an examination based on the company's risk profile or complexity of the fiduciary activities. The scope of the fiduciary examination must be sufficient to update the composite and component Uniform Interagency Trust Rating System ratings. (See PPM 5200-1 and OCC Bulletin 95-30.)

- FDICIA governs the examination requirements for insured trust companies. Therefore, a safety and soundness examination must be performed on a 12- or 18-month basis depending upon the size of the commercial assets being managed and other considerations. The scope of the safety and soundness examination of the insured trust company must be sufficient to determine the composite and CAMEL ratings. Refer to the Examination Frequency and Scope - Safety and Soundness section of this booklet for details on the determining factors of the 12- or 18-month cycle.

  In addition to the safety and soundness examination for insured trust companies, a fiduciary examination is also required. The OCC will conduct a fiduciary examination at least every 24 or 36 months, as determined by the safety and soundness cycle. For example, insured trust companies that receive a safety and soundness examination every 12 months will receive a fiduciary examination every 24 months. Likewise, insured trust companies that receive a safety and soundness examination every 24 months will receive a fiduciary examination every 36 months. The scope of the fiduciary examination must be sufficient to update the composite and component Uniform Interagency Trust Rating System ratings. (See PPM 5200-1 and OCC Bulletin 95-30.)

- Fiduciary examinations of uninsured trust companies must occur on a 24- or 36-month cycle determined by the size of fiduciary assets. Uninsured trust companies with fiduciary assets in excess of $1 billion must receive a fiduciary examination at least every 24 months. Uninsured trust companies with fiduciary assets of less than $1 billion must receive a

fiduciary examination at least every 36 months. The frequency of the fiduciary examination may be increased if the portfolio manager, with supervisory office approval, determines there is increased need for an examination based on the company's risk profile or complexity of fiduciary activities. The scope of the fiduciary examination must be sufficient to update the composite and component Uniform Interagency Trust Rating System ratings and should include an evaluation of capital adequacy. (See PPM 5200-1 and OCC Bulletin 95-30.)

Municipal Securities and Government Securities Dealers Examinations

The OCC is required by statute (Securities and Exchange Act, 17 U.S.C. 240.15B(c)(7)) to examine a bank that operates as a municipal securities dealer. While the statute does not define the full scope of the review, it does require that the OCC examine for compliance with the Municipal Securities Rulemaking Board standards. This examination must take place once every 24 months. All other activities of the dealer are examined according to the safety and soundness standards set by FDICIA.

No similar statute governs examinations for government securities dealers. In most cases, however, a government securities dealer is also a municipal securities dealer. It is OCC policy to examine government securities dealers on the same basis as municipal securities dealers, both in scope and frequency. Compliance is examined on a 24-month basis and other activities are examined on a 12- or 18-month basis as specified by FDICIA.

Types of Banks

The OCC's philosophy of supervising based on risk applies to all banks, regardless of size. To help recognize that certain banks are exposed to more risk by the nature of their activities or their culture, the OCC has divided the national banks into two broad categories, **large banks** and **community banks**.

A **large bank** is:

- A national bank with total assets of $1 billion or more.

- or -

- A national bank that is part of a multibank holding company which includes at least one national bank with assets of $1 billion or more.

When discussing large banks, the OCC's policies and processes discussed throughout this booklet apply to the consolidated large bank company. This supervisory process focuses examiners on individual banks but also requires

them to make an assessment that focuses future supervisory activities for the consolidated group. This approach recognizes that risks present in one national bank may be mitigated by activities in another affiliate. This booklet also uses the terms "lead national bank," "significant affiliate national bank," and "smaller affiliated national bank" to direct examiners in conducting specific supervisory activities. The lead national bank is the largest national bank in the company in terms of assets unless otherwise designated by the company. A significant national bank affiliate has assets of $1 billion or more. Smaller affiliated national banks are those with assets of less than $1 billion.

A **community bank** is:

- A national bank with total assets less than $1 billion.

- or -

- A national bank that is part of a multibank holding company where none of the national banks within the system has assets of $1 billion or more.

Community banks are further divided into two subsets, complex and noncomplex. This stratification allows the OCC to focus supervision more precisely on risks present in each group.

A **noncomplex community bank** has a:

- Composite rating of 1 or 2 under the Uniform Financial Institution Rating System and operates under stable conditions demonstrated by:

  – Stable bank management and ownership,
  – No significant change in operations since the last examination, and/or
  – A local economy that poses no material threat to operations.

- Management that is effective and responsive in addressing risks and conditions facing the institution.

- Consistent and strong financial performance .

- Few or limited nontraditional products.

A **complex community bank** has at least one of the following characteristics:

- Composite rating of 1 or 2 **and** unstable conditions demonstrated by:

  – Diverse markets and locations,
  – Highly competitive environment,

  - Change in bank management or ownership where the ability of the new parties is unproven,
  - Significant changes in operations since the last examination, and/or
  - An unstable local economy.

- Composite rating of 3 or worse.

- Management that has not demonstrated fully effective supervision and its performance is less than satisfactory.

- Newly chartered and/or no record of consistent and sound operations.

- Inconsistent and/or flawed financial performance.

- A number of nontraditional products that may have a potential adverse impact on the balance sheet.

Special purpose banks such as credit card, trust, etc., also are classified as complex community banks.

Exceptions

The OCC has anticipated that some exceptions to the above definitions will apply. Specifically, if a bank with total assets of $1 to $5 billion has a risk profile like that of a community bank, it may be designated a community bank, if the supervisory office approves. Similarly, a bank with total assets of less than $1 billion that has a risk profile more like that of a large bank may be designated a large bank, if the supervisory office approves. The decision to exercise these exceptions must be justified in writing.

Bank Supervision Responsibilities

The following discussion provides details regarding the respective responsibilities of those persons and entities involved in the supervision process. It does not describe the administrative functions that implement this process.

National Banks

The OCC expects the management of national banks to identify and manage the risks facing their institutions. Bank management is responsible for controlling risks by operating according to sound fundamental principles. Sound fundamental principles, such as prudent underwriting, are described in OCC issuances, laws, regulations, and the Comptroller's Handbook.

OCC

The OCC is responsible for promoting the safety and soundness of the national banking system. As part of that process, examiners assess whether risks in the banking system or in an individual bank are identified, measured, controlled, and monitored by the bank. Further, the OCC assesses the sufficiency of capital in light of the risks present.

To carry out its mission properly, the OCC must clearly communicate sound supervisory principles and standards to both banks and examiners. Those principles and standards must be clearly stated and, at the same time, encourage the use of common sense and judgment in application. For example, the need for formal written policies is affected by the complexity or volume of activity in an individual bank. The less complex or better managed an activity, the less need for a formal written policy.

Examiners carry out the OCC's mission and communicate sound fundamental principles and examination findings to banks. To facilitate consistent communication, the OCC uses portfolio managers.

Portfolio Manager

Bank portfolio management is a critical component of the OCC's supervisory process. The OCC assigns each national bank to an examiner who is responsible for the supervision of that bank and any others in the assigned "portfolio." **Every portfolio manager must be a commissioned national bank examiner.**

The portfolio manager:

- Maintains an up-to-date understanding of the risks facing the bank(s) in his or her portfolio.
- Identifies risks and responds in an appropriate and expedient manner.
- Ensures the examination cycle is planned and carried out according to OCC standards. When examination activity differs from a previously approved strategy for a bank, the activity must be approved by the supervisory office and the portfolio manager must document the reasons for the variance in the Supervisory Monitoring System (SMS).
- Maintains responsibility for all examinations, including specialty examinations.
- Keeps SMS and other computer-based systems up-to-date so that they reflect the current risk profile and condition of a bank. When

consolidated strategies are used, the portfolio manager ensures that the files of related national banks direct SMS users to pertinent information regarding the bank that is located in other affiliates' files.

- Maintains ongoing and effective communication with bank management and the board.

- Keeps the supervisory office informed of the status of the bank(s) through effective communication.

- Implements OCC and supervisory office directives.

- Recommends the strategy for the OCC to take in correcting problems based upon the nature of the problems found, the condition of the bank, and the ability and willingness of a bank's management and board of directors to correct the problems. (See PPM 5310-3, Policy for Taking Corrective Action.)

- Follows up on bank management's actions to address deficiencies noted at the prior examination.

- Follows up on any enforcement action involving an assigned bank by determining whether the bank is in compliance with the action and by assessing the effectiveness of bank management in correcting the problems.

Examiner-in-Charge

The examiner-in-charge (EIC) is the examiner assigned to conduct an examination. Often, the EIC is also the portfolio manager, but the EIC may be another commissioned examiner or a noncommissioned examiner who is appropriately supervised. Using other OCC examiners in the role of an EIC helps the OCC use resources more effectively and distributes workload more efficiently. It also provides training that is critical to the development of examiners. In situations where noncommissioned examiners act as the EIC, their work must always be appropriately overseen. At a minimum, an experienced commissioned examiner or the field manager:

- Reviews the accuracy of work the noncommissioned EIC has completed before findings are communicated to management.

- Attends any management exit meeting or board meeting to ensure consistent communication.

- Signs the report of examination.

Supervisory Office

The OCC supervisory office provides support to and oversight of the portfolio manager. The supervisory office can be the duty station, field office, district office, or national office. Personnel who carry out these responsibilities are the field manager, the appropriate director, or a combination of field manager and supervisory office staff. The supervisory office:

- Maintains overall responsibility for and knowledge of the banks within its jurisdiction.
- Evaluates and approves the EIC's recommendations, including risk assessment, CAMEL/ETCC ratings, and enforcement action referrals.
- Approves recommended corrective actions and initiates supervisory actions based on those recommendations.
- Documents decisions made about the supervision of the bank.
- Approves the risk assessment and corresponding strategy for each bank and ensures changes to strategies are made as needed.
- Ensures that scheduling of examinations for all banks meets statutory requirements.
- Works with compliance managers, field managers, and portfolio managers to ensure coordination of activities and priorities.

Supervision by Risk

Supervision by risk requires examiners to determine how certain existing or emerging issues facing a bank or the banking industry affect the nature and extent of risks in that institution. Based on that risk evaluation, examiners then structure regulatory supervisory plans and actions. Supervision by risk builds upon the risk-based supervisory philosophy historically used by the OCC. This enhancement provides consistent definitions of risk, a structure for assessing these risks, and a more integrated use of risk assessment in the supervisory process.

The OCC recognizes that banking is a business of taking risk in order to earn profits. Risk levels, however, must be appropriately managed and controlled. Banking risks also must be evaluated in terms of their significance. These assessments should be ongoing.

Supervision by risk leaves the responsibility for controlling risks with bank management. The OCC assesses how well a bank manages this risk over

time, rather than only assessing the condition at a single point in time. With supervision by risk, the OCC functions in more of an oversight than an audit role. Supervision by risk allows the OCC to supervise by concentrating on systemic risks and institutions or areas that pose the greatest risk to the system.

For the entire industry, the OCC's supervision by risk identifies areas that, in aggregate, pose the potential for presenting an unacceptable level of risk to the banking system and the federal deposit insurance fund. For those high-risk activities and/or activities that have become particularly risky because of market conditions, the OCC's goal is to communicate with, and influence, the industry through direct supervision, policy, and regulation. In situations where an individual bank is not properly managing its risks, the OCC's goal is to use appropriate means to influence bank management to adjust its practices to conform with sound fundamental banking principles.

Some risks are inherent to banking. A wide body of knowledge exists within the industry on how to identify, measure, control, and monitor these inherent risks. Supervision by risk acknowledges those inherent risks and performs limited testing in examinations directed at confirming whether adequate controls are in place. Other risks in the industry are more diverse and complex. These more sophisticated risks require enhanced controls and monitoring by both the bank and the OCC. The OCC is committed to directing its most significant resources to these complex and evolving risks, especially where they present material, actual, or potential risks to the banking system.

Risks that large banks assume are generally diverse and complex and warrant a risk-oriented supervisory approach. Under this approach, examiners do not attempt to prohibit appropriate risk-taking, but rather ensure that banks understand and control the levels and types of risk they assume. In situations where risk is not properly managed, the OCC tries to direct bank management to take corrective action so that the bank is managed in a safe and sound manner. In all cases, the OCC's supervisory focus is to ensure that bank management identifies, measures, controls, and monitors risks to ensure sufficient capital is present in light of the risks.

Risks that community banks assume are generally less diverse and complex than those of larger banks. Under this approach, examiners verify the existence of adequate controls and risk management systems by testing transactions. Examiners will focus attention on the risk management systems and the methods management uses to identify, measure, control, and monitor risk in those community banks or in areas that are more diverse and complex.

Supervision by risk allocates greater resources to those areas with higher risks. The OCC accomplishes this by:

- Identifying risks using common definitions. This set of risks forms the basis for supervisory assessments and actions.

- Measuring risk based on common evaluation factors. Risk measurement is not always quantified in dollar terms; it is sometimes a relative assessment of exposure. For example, numerous internal control deficiencies may indicate a bank has an excessive amount of transaction risk.

- Evaluating risk management to determine if bank systems adequately manage and control the identified risk levels. The sophistication of the systems will vary based on the level of risk present and the size and/or complexity of the institution.

- Assigning greater resources to areas of higher or increasing risk, both within an individual institution and among banks in general. This is done through the supervisory strategy.

- Performing examinations based on the risks, reaching conclusions on risk profile and condition, and following up on areas of concern.

To accomplish these tasks, examiners should discuss preliminary conclusions of this risk-based supervisory strategy with bank management and adjust conclusions and strategies based on these discussions, if appropriate. The OCC can then focus supervisory efforts on significant risks, i.e., the areas of highest risk within a bank and within the banking system.

Examiners must focus on the consolidated company risk profile to fully implement supervision by risk. This consolidated approach recognizes that risks at individual institutions may be mitigated or increased on a company-wide basis. Individual bank risk profiles, however, must be determined for the lead bank and significant national bank affiliates for the examiner to fully evaluate the consolidated risk profile.

In summary, the supervision by risk approach provides the OCC and the banking industry with:

- A high level of consistency in supervision because it sets and uses minimum core procedures.

- An allocation of resources based on risk.

- Sufficient flexibility to allow examiners to tailor the supervisory effort to the risks present.

- Less supervisory intervention in areas of low risk.

- Help in determining the sufficiency of each bank's capital and risk management systems.

Definition of Risk

For purposes of the OCC's discussion of risk, the OCC assesses banking risk by its impact to capital and earnings. From a supervisory perspective, risk is the potential that events, expected or unanticipated, may have an adverse impact on the bank's capital or earnings.

The simple existence of risk is not necessarily reason for concern. To put risks in perspective, examiners should decide if the risks a bank is undertaking are warranted. Generally, risks are warranted when they are understandable, measurable, controllable, and within the bank's capacity to readily withstand adverse performance. If examiners determine risks are unwarranted, they must communicate with management and the directorate to mitigate or eliminate the unwarranted risks. Appropriate actions for the bank to take may include reducing exposures, increasing capital, or strengthening risk management processes.

Risk Management

Because market conditions and company structures vary, no single risk management system works for all companies. Each institution should develop its own risk management program tailored to its needs and circumstances. The sophistication of the risk management system will increase with the size, complexity, and geographic diversity of each bank or company. All sound risk management systems, however, have several common fundamentals. For example, bank staff responsible for implementing sound risk management systems perform those duties independent of the bank's risk-taking activities. Regardless of the risk management program's design, each program should include:

- Risk identification. Proper risk identification focuses on recognizing and understanding existing risks or risks that may arise from new business initiatives. Risk identification should be a continuous process, and should occur at both the transaction and portfolio level.

- Risk measurement. Accurate and timely measurement of risks is a critical component of effective risk management. A bank that does not have a

risk measurement system has limited ability to control or monitor risk levels. Further, the sophistication of the risk measurement tools a bank uses should reflect the complexity and levels of risk it has assumed. The bank should periodically verify the integrity of the measurement tools it uses. Good risk measurement systems assess both individual transactions and portfolios.

- Risk control. The bank should establish and communicate limits through policies, standards, and/or procedures that define responsibility and authority. These control limits should be meaningful management tools that can be adjusted if conditions or risk tolerances change. The bank should have a process to authorize exceptions or changes to risk limits when they are warranted.

- Risk monitoring. Banks should monitor risk levels to ensure timely review of risk positions and exceptions. Monitoring reports should be frequent, timely, accurate, and informative; and should be distributed to appropriate individuals to ensure action when needed.

Effective risk management requires an informed board of directors. The board must guide the company's strategic direction. A key component of strategic direction is endorsing the organization's risk tolerance by approving policies that set standards, either orally or in writing. Well-designed monitoring systems allow the board to hold management accountable for operating within established tolerance levels.

Capable management and appropriate staffing also are critical to effective risk management. Bank management is responsible for the implementation, integrity, and maintenance of risk management systems. Management also must keep the directors adequately informed. Management must:

- Implement the company's strategic direction.

- Develop policies, formal or informal, that define the institution's risk tolerance that are compatible with the bank's strategic goals.

- Oversee the development and maintenance of management information systems to ensure they are timely, accurate, and informative.

- Ensure that strategic direction and risk tolerances are effectively communicated and adhered to throughout the organization.

When examiners assess risk management systems, they consider policies, processes, personnel, and control systems. A significant deficiency in one or more of these components constitutes a deficiency in risk management. All

of those systems are important, but the sophistication of each will vary depending upon the complexity of the bank. Noncomplex community banks normally have less formalized policies, processes, and control systems in place than do large banks.

- **Policies** reflect the bank's intent and commitment to pursuing desired results. They set standards and courses of action to pursue, implement, or enforce specific objectives. Good policies link with, and reflect, a bank's underlying mission, values, and principles. They also clarify the bank's tolerance for risk. Mechanisms should be in place to trigger a review of policies in the event that activities or tolerances change. Policies may be written or unwritten depending upon the effectiveness of management and the complexity of the area or bank. In any event, standards should be articulated and adhered to in practice.

- **Processes** are the procedures, programs, and practices that govern how a bank will pursue its objectives. Processes define how daily activities are carried out. Good processes are consistent with the underlying policies, are efficient, and include checks and balances.

- **Personnel** are the staff and managers that execute or oversee performance of the processes. Good staff and managers are qualified, competent, and perform as expected. They understand the bank's mission, values, policies, and processes. Compensation programs should be designed to attract, develop, and retain qualified personnel.

- **Control systems** are tools and information systems that bank managers use to measure performance, make decisions, and assess effectiveness of existing processes. These feedback devices must be timely, accurate, and informative. They measure performance and assist in decision-making.

Categories of Risk

The OCC has defined nine categories of risk for bank supervision purposes. These risks are: **Credit, Interest Rate, Liquidity, Price, Foreign Exchange, Transaction, Compliance, Strategic, and Reputation**. These categories are not mutually exclusive, any product or service may expose the bank to multiple risks. For analysis and discussion purposes, however, the OCC identifies and assesses the risks separately.

Credit Risk

Credit risk is the risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the bank or otherwise fail to perform as

agreed. Credit risk is found in all activities where success depends on counter-party, issuer, or borrower performance. It arises any time bank funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements, whether reflected on or off the balance sheet.

Credit risk is the most recognizable risk associated with banking. This definition, however, encompasses more than the traditional definition associated with lending activities. Credit risk also arises in conjunction with a broad range of bank activities, including selecting investment portfolio products, derivatives trading partners, or foreign exchange counter-parties. Credit risk also arises due to country or sovereign exposure, as well as indirectly through guarantor performance.

Interest Rate Risk

Interest rate risk is the risk to earnings or capital arising from movements in interest rates. The economic perspective focuses on the value of the bank in today's interest rate environment and the sensitivity of that value to changes in interest rates. Interest rate risk arises from differences between the timing of rate changes and the timing of cash flows (repricing risk); from changing rate relationships among different yield curves affecting bank activities (basis risk); from changing rate relationships across the spectrum of maturities (yield curve risk); and from interest-related options embedded in bank products (options risk). The evaluation of interest rate risk must consider the impact of complex, illiquid hedging strategies or products, and also the potential impact on fee income which is sensitive to changes in interest rates. In those situations where trading is separately managed this refers to structural positions and not trading portfolios.

The assessment of interest rate risk should consider risk from both an accounting perspective (i.e., the effect on the bank's accrual earnings) and the economic perspective (i.e., the effect on the market value of the bank's portfolio equity). In some banks, interest rate risk is captured under a broader category of market risk. In contrast to price risk, which focuses on the mark-to-market portfolios (e.g., trading accounts), interest rate risk focuses on the value implications for accrual portfolios (e.g., held-to-maturity and available-for-sale accounts).

Liquidity Risk

Liquidity risk is the risk to earnings or capital arising from a bank's inability to meet its obligations when they come due, without incurring unacceptable losses. Liquidity risk includes the inability to manage unplanned decreases or changes in funding sources. Liquidity risk also arises from the bank's failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value.

As with interest rate risk, many banks capture liquidity risk under a broader category – market risk. Liquidity risk, like credit risk, is a recognizable risk associated with banking. The nature of liquidity risk, however, has changed in recent years. Increased investment alternatives for retail depositors, sophisticated off-balance sheet products with complicated cash-flow implications, and a general increase in the credit sensitivity of banking customers are all examples of factors that complicate liquidity risk.

Price Risk

Price risk is the risk to earnings or capital arising from changes in the value of portfolios of financial instruments. This risk arises from market-making, dealing, and position-taking activities in interest rate, foreign exchange, equity, and commodities markets.

Many banks use the term price risk interchangeably with market risk. This is because price risk focuses on the changes in market factors (e.g., interest rates, market liquidity, and volatilities) that affect the value of traded instruments. The primary accounts affected by price risk are those which are revalued for financial presentation (e.g., trading accounts for securities, derivatives, and foreign exchange products).

Foreign Exchange Risk

Foreign exchange risk is the risk to earnings or capital arising from movement of foreign exchange rates. This risk is found in cross-border investing and operating activities. Market-making and position-taking in foreign currencies is price risk.

Foreign exchange risk is also known as translation risk and is sometimes captured as a component of market risk. Foreign exchange risk arises from accrual accounts denominated in foreign currency, including loans, deposits, and equity investments (i.e., cross-border investing). Accounting conventions require quarterly revaluation of these accounts at current rates. This revaluation translates the foreign denominated accounts into U.S. dollar terms.

Transaction Risk

Transaction risk is the risk to earnings or capital arising from problems with service or product delivery. This risk is a function of internal controls, information systems, employee integrity, and operating processes. Transaction risk exists in all products and services.

Transaction risk is also referred to as operating or operational risk. This risk arises on a daily basis in all banks as transactions are processed. It is a risk that transcends all divisions and products in a bank.

Compliance Risk

Compliance risk is the risk to earnings or capital arising from violations of, or nonconformance with, laws, rules, regulations, prescribed practices, or ethical standards. Compliance risk also arises in situations where the laws or rules governing certain bank products or activities of the bank's clients may be ambiguous or untested. Compliance risk exposes the institution to fines, civil money penalties, payment of damages, and the voiding of contracts. Compliance risk can lead to a diminished reputation, reduced franchise value, limited business opportunities, lessened expansion potential, and lack of contract enforceability.

Compliance risk is often overlooked as it blends into operational risk and transaction processing. A portion of this risk is sometimes referred to as legal risk. This is not limited solely to risk from failure to comply with consumer protection laws; it encompasses all laws as well as prudent ethical standards and contractual obligations. It also includes the exposure to litigation from all aspects of banking, traditional and nontraditional.

Strategic Risk

Strategic risk is the risk to earnings or capital arising from adverse business decisions or improper implementation of those decisions. This risk is a function of the compatibility of an organization's strategic goals, the business strategies developed to achieve those goals, the resources deployed against these goals, and the quality of implementation. The resources needed to carry out business strategies are both tangible and intangible. They include communication channels, operating systems, delivery networks, and managerial capacities and capabilities.

Strategic risk focuses on more than an analysis of the written strategic plan. It focuses on how plans, systems, and implementation affect the bank's franchise value. It also incorporates how management analyzes external factors that impact the strategic direction of the company.

Reputation Risk

Reputation risk is the risk to earnings or capital arising from negative public opinion. This affects the institution's ability to establish new relationships or services, or to continue servicing existing relationships. This risk can expose the institution to litigation, financial loss, or damage to its reputation. Reputation risk exposure is present throughout the organization and is why banks have the responsibility to exercise an abundance of caution in dealing with its customers and community. This risk is present in activities such as asset management and agency transactions.

The assessment of reputation risk recognizes the potential impact of the public's opinion on a bank's franchise value. This risk is inherent in all bank activities. Banks which actively associate their name with products and services, such as with fiduciary services, are more likely to have higher reputation risk exposure. As the bank's vulnerability to public reaction increases, its ability to offer competitive products and services may be affected.

Measuring and Assessing Risk

To ensure effective supervision by risk, the OCC requires a common framework to document decisions about risk. The risk assessment system (RAS) provides a concise method of communicating and documenting judgments regarding the quantity of risk, the quality of risk management, the level of supervisory concern (measured as aggregate or composite risk), and the direction of risk. The common definitions explained above are critical to identifying risks consistently. A list of evaluation factors that examiners should consider in making the assessments is also provided. These evaluation factors are not mandatory checklists, but rather provide an overview of issues that can assist the examiner in making decisions within the RAS.

Assessments of risk in the RAS must reflect both a current and prospective view of the company's or bank's risk profile. This assessment drives supervisory strategies and activities. It also facilitates discussions with bank management and directors and helps to ensure more efficient examinations.

The RAS is used for all banks. The OCC has, however, developed two versions of the RAS, one for community banks and one for large banks. This allows for a common supervisory philosophy while recognizing the differing levels and complexities of risk present in each bank.

Examiners should discuss conclusions from the RAS with appropriate bank management and the board. Bank management's input may help clarify or modify the examiner's RAS conclusions. While the OCC does not require bankers to adopt a similar process, examiners must effectively communicate the rationale for their decisions in evaluating risk to ensure effective supervision. These discussions will help the OCC and bank management reach a common understanding of the risks, focus on the strengths and weaknesses of risk management, and ensure that future supervisory plans are achieved.

The Risk Assessment System for Large Banks

Once the risks in a company are identified using the common definitions explained above, examiners use the common framework provided by the RAS

to assess the risk exposure for the nine types of risk. For seven of the risks (Credit, Interest Rate, Liquidity, Price, Foreign Exchange, Transaction and Compliance), the supervisory process includes an assessment of the:

- **Quantity of risk**, which is the level or volume of risk that exists and is assessed as high, moderate, or low.

- **Quality of risk management**, which includes how well risks are identified, measured, controlled, and monitored and is assessed as weak, acceptable, or strong.

- **Aggregate risk**, which is a summary judgment that reflects the level of supervisory concern considering both the quantity of risk and the quality of risk management, weighing the relative importance of each. The examiner's assessment of aggregate risk may be impacted by mitigating factors, not necessarily considered in the quantity of risk and quality of risk management decisions. An example of a mitigating factor is insurance. Aggregate risk is assessed as high, moderate, or low. Aggregate risk assessments direct the specific activities and resources outlined in supervisory strategies.

- **Direction of risk**, which indicates the likely changes to the risk profile over the next 12 months and is assessed as decreasing, stable, or increasing. Decreasing direction indicates the examiner anticipates, based on current information, that the aggregate risk will decline over the next 12 months. Stable direction indicates the examiner anticipates that aggregate risk will remain unchanged. Increasing direction indicates the examiner anticipates that aggregate risk will be higher 12 months in the future. When aggregate credit risk is moderate and direction is decreasing, the examiner can anticipate that aggregate credit risk will be low or lower in 12 months. The direction of risk often influences the supervisory strategy.

For the other two categories of risk, strategic risk and reputation risk, examiners' judgment of risk is less quantifiable. These risks affect the bank's franchise value but are not direct risks that examiners can precisely measure in an examination. These risks require examiners to consult with supervisory offices to ensure all elements are considered. Given the less explicit nature of these risks, the OCC's risk assessment and measuring process is modified. For strategic risk and reputation risk, the supervisory process includes an assessment of the:

- **Composite risk**, which is a summary judgment that reflects the level of supervisory concern incorporating all elements that affect strategic risk and reputation risk. It is assessed as high, moderate, or low. Composite

risk assessments direct the specific activities and resources outlined in supervisory strategies.

- **Direction of risk**, which is the examiners' view of likely changes to the risk profile over the next 12 months, as explained above. It is assessed as decreasing, stable, or increasing.

The combined assessments of each significant national bank allow the examiner to assess the consolidated risk profile of the holding company. The relative importance of each risk, both for the individual bank and for the holding company, should influence the development of the strategy and the assignment of resources.

Examiners should complete a **consolidated** RAS quarterly. Examiners must also complete the RAS for each significant national bank affiliate every 12 months. The bank RAS should be updated more frequently if deemed appropriate based on the consolidated risk profile. The consolidated and individual bank RAS conclusions are recorded in SMS.

The Risk Assessment System for Community Banks

For community banks, the OCC has defined a less stringent system for assessing each major risk category. This system, however, still allows a consistent means of measuring the risk and determining which procedures will be performed. In the community bank RAS, the examiner rates the aggregate risk or composite risk as either high, moderate, or low for each of the nine risk categories. The aggregate risk decision for community banks directly incorporates both the quantity of risk and the quality of risk management into a single decision process. A list of evaluation factors, similar to those established for the large bank RAS, supplement the decision process. A prospective analysis of the direction (stable, increasing, decreasing) of risk is also performed.

Examiners should complete the RAS for community banks at the end of each examination cycle. It should be updated any time the examiner becomes aware of changes to the risk profile on an interim basis. The RAS for individual banks is recorded in SMS. For further discussion of the RAS for community banks, see the Community Bank Risk Assessment System section of the Comptroller’s Handbook.

The Application of Risk to National Bank Supervision

In completing the RAS, the examiner determines the level of supervisory concern and direction of risk for each risk category. This decision will determine the examination procedures to be used in the full scope, on-site

examination or other targeted examinations. The examination procedures have two broad orientations or starting points for examiners to use – **performance-** or **process-oriented** procedures.

For low-risk areas or banks, the OCC will define a minimum core set of procedures. If, after those procedures have been performed, the examiner concludes the risk is the same or adequate conclusions can be reached, no further procedures will be performed. If, however, risks have changed since the original assessment, the minimums can be expanded, with supervisory office approval. This expansion may include additional testing of transactions or a review of a bank's risk management systems. This approach focuses on minimum examination activity for low-risk areas and provides consistency between examinations. Examiners remain able to respond to increased risks by expanding procedures.

Note: Except for the "Community Bank Procedures for Noncomplex Banks" and "Community Bank Consumer Compliance," existing procedures (i.e., The Comptroller's Handbook) do not yet identify minimum core procedures. Minimum core procedures will be released as they are completed.

Performance-oriented Examinations

Performance-oriented examinations focus the examiner on the bank's practices, rather than on the bank's systems and policies. Performance-oriented testing is effective for areas or banks that appropriately manage and control the risks they face and, therefore, are appropriate for low-risk areas of community banks. This approach tests transactions and confirms the use of sound fundamental principles in a bank. If sound fundamental principles are followed, the OCC is not concerned about the method management has used to achieve the results. Stated differently, examinations of low-risk areas in a community bank do not directly focus on the quality of risk management. The performance-oriented procedures, however, direct examiners to reach a conclusion about the quality of risk management based upon the results of transaction testing.

Examiners use the minimum performance-oriented procedures (currently defined as community bank procedures for noncomplex banks) for all low-risk areas of community banks. For consumer compliance examinations in community banks with total assets less than $250 million or other low-risk community banks examination activities are those outlined in "Community Bank Consumer Compliance" and appropriate Community Reinvestment Act (CRA) procedures. For areas of moderate or high risk in a community bank, the examiner will target the specific area for further examination. Additional examination procedures are added to focus attention on systems and controls, i.e., process-oriented procedures.

Process-oriented Examinations

Process-oriented examinations focus the examiner on the bank's method for identifying, measuring, controlling, and monitoring risks. Limited transaction testing supplements the review of risk management. This approach to examining focuses on the root cause of systemic problems and allows for early recognition of problems. If flaws exist in management's processes for controlling risks, the examiner recommends corrective action.

For large banks, examiners will always perform process-oriented procedures. For areas of low risk in a large bank, they will perform minimum procedures. For areas of moderate or high risk, they will customize procedures beyond the minimums to ensure appropriate assessment of the risks. At present, the Comptroller's Handbook lays out comprehensive process-oriented procedures. In the future, the OCC will release minimum core procedures as they are completed.

Process-oriented procedures are also appropriate for areas of moderate or high risk in a community bank. These procedures supplement the performance-oriented testing and focus supervisory activities on the quality of risk management.

Relationship of Risk and CAMEL

The OCC assigns component and composite ratings for each institution using the established Uniform Interagency Rating System, or CAMEL. The rating system provides a general framework for evaluating and assimilating all significant financial, operational, management, and compliance factors and allows OCC to assign a summary supervisory rating for each national bank. The rating comprehensively and consistently reflects the institution's financial condition, its compliance with laws and regulations, its management ability, and its overall operational soundness.

CAMEL ratings for each institution must be determined and confirmed at the conclusion of its examination cycle. The composite rating and specialty ratings (ETCC) must be communicated to the board in the report of examination with a discussion of any significant findings in the component elements. The CAMEL/ETCC ratings measure a bank's condition at that point in time.

The assessment of risk in a given bank or product has a different, but inter-related purpose. Assessing risk allows examiners to determine how they will examine each particular bank. The Risk Assessment System provides a method of identifying, evaluating, documenting, and communicating examiner judgment about both the quantity of risk and the quality of risk management

in each bank. This assessment reflects both a current and a prospective view of the institution's risk profile. This posture allows the OCC to deploy the greatest resources to those areas of highest or increasing risk.

The CAMEL rating and risk assessment are not directly tied to each other, although they are related. For example, a community bank with a composite CAMEL rating of 4 may not be high risk in all areas. The CAMEL rating reflects past practices and their effect on the current condition of the bank, while the risk assessment focuses attention on future prospects.

The Supervision Process

The supervision of banks is a cyclical, ongoing process of planning and examining. Communication of the results of examining and supervisory planning is also an integral part of the supervision process. This communication facilitates dialogue between bankers and examiners that ensures supervisory activities add value to both the bank and the OCC.

Planning

Planning is essential to effective supervision. Planning requires thoughtful assessment of existing and potential risks for the bank. Planning also requires effective and periodic communication with bank management thereby helping to ensure supervisory resources are directed at the areas of highest risk in the least intrusive manner. Planning includes the development of detailed strategies to provide effective, efficient supervision for each bank or company.

All supervisory plans are developed by the portfolio manager for a community bank or the EIC, in collaboration with the supervisory office, for a large bank. The plan must incorporate the timing of the required statutory examination and the next scheduled and applicable specialty examinations (i.e., BIS, compliance, fiduciary, and government and municipal dealers). The strategies must also cover a sufficient time period to allow for effective planning and scheduling. Specifically,

- For a **large bank** on a 12-month statutory examination cycle, the plan must encompass 15 months (5 quarters) so that it always covers 12 months when it is next updated.

- For a **community bank**, the plan must detail fully the statutory examination and any known targeted examinations that may occur in the examination cycle.

The foundation for planning occurs when the examiner completes the RAS. The conclusions from the RAS are implemented into specific examination plans through the development of a supervisory strategy. Supervisory strategies guide the examiner's activities throughout the supervision process and direct examination activities.

Supervisory strategies are dynamic documents reviewed and updated frequently based on company, industry, and economic developments. Examiners should discuss supervisory strategies with bank management as they are formulated. Examiners should also discuss with bank management significant modifications to those strategies.

For large banks, the supervisory strategy should focus examiners' efforts on monitoring the continued effectiveness of the bank's risk management processes and seeking bank management's commitment to corrective action of previously identified deficiencies. When possible, supervisory activities should rely on the bank's internal systems, including its internal and external audit activities, to assess the condition and the extent of risks. This allows the OCC to assess a bank's condition and risks in the most efficient, and least intrusive, manner.

For community banks, the supervisory strategy should focus examiners' efforts on verifying the bank's condition. In situations of higher risk and complexity, the examination focus should be increased to include an assessment of risk management processes and seeking bank management's commitment to corrective action of previously identified deficiencies. As with large banks, supervisory activities that focus on risk management processes should, when possible, rely on the bank's internal systems, including its internal and external audit activities, to assess the condition and the extent of risks.

OCC examiners develop consolidated supervisory strategies for each large bank company. If necessary, consolidated strategies can be supplemented by plans specific to one or more of the affiliated national banks. The strategy addresses nonbank and state bank affiliates only to the extent that risks associated with their activities are likely to affect the national banks in the company. When multibank holding companies are led by a state bank, the OCC will make every effort to coordinate strategies for examining the national bank affiliates with the examining plans of the primary regulatory agency for the lead bank.

The OCC supplements individual bank risk-based strategies with a supervisory operating plan. The supervisory operating plan addresses specific supervisory concerns in the national banking system during a particular time period. The strategy of each national bank incorporates operating plan requirements as well as supervisory objectives particular to individual risks.

Each supervisory strategy is based on:

- The OCC's knowledge of the bank, including its:
  - Management.
  - Risk profile.
  - Strengths and weaknesses.
  - Supervisory history.
  - Market(s).

- Applicable economic conditions and their potential or actual impact on the institution.

- OCC supervisory guidelines, standards, and priorities.

- Statutory examination requirements.

Responsibilities for the Supervisory Strategy

- **Portfolio Manager**

  The portfolio manager is accountable for the content of the supervisory strategy. For large banks, the portfolio manager is the EIC. The portfolio manager ensures the supervisory strategy is current and reflects appropriate supervisory activities based on the complexities of the bank. The portfolio manager conducts the minimum monitoring activities, generally acts as EIC for the examination, and ensures the supervisory strategy is followed. All strategy comments entered into SMS must contain the name of the portfolio manager and the date data is entered or changed.

- **Supervisory Office**

  The supervisory office (SO) is responsible for ensuring the supervisory strategy is current and reflects appropriate activities commensurate with the institution's risk and OCC policy. The SO approves the supervisory strategy and any changes to it.

Elements of the Supervisory Strategy

The supervisory strategy for a bank has three components: objectives, activities, and work plans.

- **Objectives** define the goals of supervision for the specific institution or

company, based on its risk profile. They are the foundation for all activities and workplans. Well-defined objectives allow supervisory activities to be focused and efficient. They also help OCC managers ensure consistent and appropriate application of supervisory policy and resources. The objectives must be clear, attainable, specific, and action-oriented.

The objectives for noncomplex community banks are outlined in the "Community Bank Procedures for Noncomplex Banks." The objectives for consumer compliance examinations for banks under $250 million in assets are outlined in "Community Bank Consumer Compliance." Likewise, the objectives for large banks are outlined in the "Large Bank Supervision" booklet.

- **Activities** are the steps the OCC will perform to achieve the objectives. Each activity must link directly to one or more supervisory objectives. Activities drive workplans, including requests for examining resources. Activities must directly correlate to the level of risk identified. Activities also detail communication plans, including board meetings, and the frequency of communication.

  OCC activities should not assume burdens and incur costs that belong to the bank. Once the OCC has identified a problem or deficiency and its potential cause, the bank should use its resources to fully determine the extent of the particular deficiency. The OCC will review that work and test its reliability. The exception to this standard arises in failing banks, where examiners may do detailed evaluations of the depth and nature of the problem. **Examiners should avoid activities beyond those needed to reach a justifiable conclusion.** In particular:

  - For a **large bank** that has no significant deficiencies or that has substantially corrected any identified weaknesses, the activities should focus on ensuring that systems continue to properly function to effectively manage risks. The procedures are process-oriented. Examiners use a bank's internal systems to assess condition and the extent of risks. Activities should include periodic testing of internal systems to verify accuracy and reliability. For areas of higher risk, activities should include specific actions to assess the systems and test for improvement or deterioration.

  - For a **community bank** that is **designated noncomplex** and reflects low risk in safety and soundness, activities are simply those outlined in the "Community Bank Procedures for Noncomplex Banks." Completion of those activities is sufficient to satisfy the scope for a full-scope, on-site examination. Activities for consumer compliance examinations in community banks with total assets less than $250

million or other low-risk community banks are those outlined in "Community Bank Consumer Compliance" and appropriate CRA procedures. Activities to address specialty areas not covered by the core procedures and areas of higher risk must be added to that base. In all community bank examinations where risk is low, examination activities should focus on performance rather than the methods employed by management to achieve the results.

- For a **community bank designated complex**, OCC activities must address the higher risks present. The safety and soundness activities begin with "The Community Bank Procedures for Noncomplex Banks" and expand for areas of higher risk. Higher risk areas in a complex community bank require activities that are process-oriented and include transaction testing to verify risk management processes.

- **Work plans** describe how strategies will be achieved. They outline the scope, timing, and resources needed to meet the supervisory objectives and activities.

Coordination with Other Regulators

The OCC office that has supervisory authority for the lead national bank of a multibank holding company, the national bank affiliates of a multibank holding company with a lead state bank, or the lead national bank in a chain banking group is responsible for coordinating the examinations of affiliated national banks in the organization with other regulatory agencies and OCC supervisory offices, as applicable.

When supervisory responsibility for an institution is shared with other regulatory agencies, the portfolio manager follows the established interagency guidelines found in the "Examination Planning and Control" booklet of the Comptroller's Handbook. For example, the portfolio manager of an independent data center should follow the Federal Financial Institutions Examination Council (FFIEC) policies and procedures when supervisory responsibility for the data center is shared with other federal regulatory authorities.

Interagency guidelines adopted June 10, 1993, are intended to:

- Eliminate duplicate examinations by multiple agencies.

- Increase coordination of examinations among agencies when duplication is necessary.

- Establish procedures to centralize and streamline examinations in multibank organizations.

OCC also coordinates supervision in its planning relating to Shared National Credits (SNC) (PPM 5100-2), the results of decisions by the Interagency Country Exposure Review Committee (ICERC), Multiregional Data Processing Services (MDPS) (PPM 5300-1), the OCC and Securities and Exchange Commission (SEC) Joint Examination Agreement, and the Agreement in Principal between the OCC and National Association of Securities Dealers (NASD).

Examining

Once a supervisory strategy is in place, examiners must implement that strategy through examining. Examining is more than just on-site activities that result in an examination report. It includes discovery of a bank's condition, ensuring correction of significant deficiencies and monitoring ongoing activities. The OCC has established a minimum level of activity that must occur during the supervisory cycle. Examiners must perform sufficient work to determine the overall CAMEL condition of the bank and at least some of this work must be conducted on-site. In large banks, much of this required scope is conducted throughout the 12 months through various target examinations. These target examinations may address a portion of the required scope or they may encompass other examination work focused on specialty areas or other risks. In the smaller national bank affiliates and community banks, the on-site examination generally occurs at one time during the 12- or 18-month period.

Discovery

Supervision begins with understanding the bank and the degree of control provided by risk management systems. Discovery is part of the exam process, and involves gaining a fundamental understanding of the condition of the bank, the quality of management, and the degree of control provided by risk management systems. The understanding of the bank that examiners gain through discovery focuses the other steps of the supervision process to those areas of major concern.

For large banks, a primary objective of discovery is to verify the integrity of internal risk management systems. This verification process includes appropriate independent testing by examiners, the extent of which should reflect the level or degree of risk present in the bank. For low-risk areas of community banks, the primary objective of discovery is to verify the bank's condition through minimum testing. For higher risk areas in community banks, the objective of discovery is expanded to include verification of the integrity of internal risk management systems.

In discovery, examiners:

- Evaluate the bank's condition.

- Perform sufficient testing to verify the integrity of internal risk management systems.

- Identify significant risks.

- Quantify the risk, where possible and practical.

- Evaluate management and the board's awareness and understanding of the significant risks facing the institution.

- Assess the quality of risk management systems.

- Identify unacceptable levels of risk, deficiencies in risk management systems, and underlying causes.

The initial judgments and evaluations examiners make during discovery form the foundation for future supervisory activities. Discovery is continuous and allows examiners to periodically confirm and update their assessments to reflect current or emerging risks.

Ongoing discovery is important even while pursuing the correction of material deficiencies. New deficiencies can arise during the process of correcting others. This can occur either directly or indirectly. For example, corrective action taken may be flawed, creating a new or unanticipated problem. Or, the attention focused on one deficiency may result in lax controls in another area.

Discovery is dynamic. The timing, subjects covered, and detail of activities performed are based on the circumstances present in the bank. As those circumstances change, the examiner's approach to discovery should also change. For example, a bank is characterized as a noncomplex community bank based on historical experience and current knowledge that the risks it has undertaken are well-managed and low. In such a bank, the on-site examination is limited to transaction testing. If that testing identifies additional risks, the process of discovery changes and the examination scope is expanded.

Examiners must revalidate the reliability of bank systems as often as appropriate, given the risk level. Examiners also must regularly revalidate the effectiveness of bank practices, policies, and programs. Although revalidation is critical, examiners must balance the need to revalidate with the cost and

appropriateness of revalidation. Examiners must justify in SMS why revalidation is appropriate.

Discovery is often supplemented by work performed by others. In particular, the OCC can use information generated by external or internal accountants or loan review. Examiners must, however, periodically verify and test the validity of such external information to determine its reliability.

Correction

Correction is the process of addressing identified material deficiencies in risk management systems or unacceptable risk levels. Correction also ensures actions taken by the bank have been successful. In correction, examiners:

- Review bank-prepared action plans to resolve each significant deficiency, including the appropriateness of the time frames for correction.
- Verify that the bank is executing the plans.
- Evaluate whether actions the bank has taken or plans to take address deficiencies.
- Pursue alternate strategies to achieve correction if the bank's actions or planned actions are not effective.

In encouraging banks to correct deficiencies, examiners should ensure that banks address the root causes of problems rather than their symptoms. This may require management to develop new systems or improve the design and implementation of existing systems.

Action plans prepared by the bank should detail steps or methods management expects will cure the root causes of deficiencies. The sophistication of those plans will vary based on the complexity of the bank and/or the complexity of the problem being addressed. Bank management is responsible for developing and executing corrective action plans. Directors are expected to hold management accountable for executing those action plans. The OCC's role is to verify that the plan has been executed and validate its success. Examiners must consider the responsiveness of the bank in recognizing the problem and formulating an effective solution when determining if they need to take further action. When a bank is unresponsive or unable to effect the resolution, the OCC will take more formal steps to ensure the deficiencies are corrected.

Banks' action plans should:

- Address the underlying root causes of significant deficiencies.
- Specify actions to correct deficiencies.

- Set realistic time frames for completion.
- Establish benchmarks to measure progress towards completion.
- Identify the person(s) in the bank who will be responsible for correction.
- Detail how the board and management will monitor and assure effective execution of the plan.

Monitoring

Ongoing monitoring allows the OCC to respond to risks facing an individual bank or the industry as a whole in a timely manner. Monitoring occurs in all types of supervision activities.

While monitoring is critical to effective supervision for all banks, it can be achieved in different ways based on the individual risks present in individual banks. An assessment of the risks present and the condition of the bank allows the OCC to achieve effective supervision through monitoring without burdening the institution.

In monitoring a bank, examiners:

- Identify current and prospective issues that impact the risk profile or overall condition of a bank through discussions with management or performance of examinations.
- Consider the focus of future supervisory strategies.
- Observe and measure the bank's progress toward correcting identified deficiencies.

When monitoring an institution, examiners should request only essential material. Material requested must always be related to the risks present in the bank and its supervisory strategy. The examiner must review any items requested and provide feedback to the bank within 30 days of receipt.

Monitoring must be tailored to each bank; the more complex an institution, the greater the need for more frequent and comprehensive oversight. The OCC has established minimum requirements for monitoring activities for both large and community banks.

For **large banks,** monitoring activities are directed at the consolidated company, although appropriate tailoring of activities must include the risks facing each significant national bank affiliate. In addition to assessing progress in executing plans and correcting deficiencies, the OCC has established the

following minimum requirements for monitoring activities for large banks.

On a quarterly basis examiners must:

- Analyze or review the company-prepared analysis of the financial condition of the company and its significant operating units.

- Ensure that no significant issues are identified which may change the CAMEL, BIS, fiduciary, consumer, and CRA ratings for the lead bank or any significant affiliate national banks. If an issue is identified that may affect the rating, the examiner must update the appropriate rating or adjust the bank's supervisory strategy to reflect the change in condition.

- Evaluate the consolidated risk of the company using the RAS. The lead national bank and significant affiliate national bank risk profiles must, at a minimum, be updated using the RAS after the completion of the 12-month supervisory cycle. The examiner should, however, update the RAS for each national bank more frequently if significant changes occur in the risk profile.

- Review and update the supervisory strategy for the company and data in the OCC's SMS to ensure it is current and accurate. Changes for individual bank strategies should be made if warranted. Examiners should discuss any significant changes with bank management.

For **community banks**, monitoring activities are directed at confirming corrective action has been taken, modifying strategies in response to changing risks, and providing a medium for responding to bank management's questions. Monitoring of community banks should focus on changes in condition or risk profile and implementation of bank action plans. This ensures a more focused on-site examination. Monitoring activities at community banks may take only a few hours to complete the review, reconfirm risks, and document findings. Generally, the more complex the bank, the greater the amount of time needed to monitor its activities.

For a community bank, examiners must at a minimum perform:

- A brief quarterly financial analysis of the bank to assess any significant trend. This financial analysis uses the Uniform Bank Performance Report (UBPR), the Bank Expert system (BERT), or other computer-generated analysis tools. This brief analysis captures significant positions and

changes in the financial condition. The only required documentation of this analysis is a brief conclusion on significant changes in condition or risk profile.

- A quarterly phone discussion or on-site meeting with senior management

to solicit current information about the bank and establish or maintain lines of communication. All on-site meetings must be justified and approved in advance by the supervisory office. Typical discussion topics include:

- Financial performance and trends.
- New lines of business or other operating changes.
- Management concerns about the bank or OCC's supervision.
- Other issues that may affect the risk profile.

- An assessment of progress in correcting Matters Requiring Board Attention (MRBA) or enforcement actions, as needed.

Community bank monitoring activities should allow the examiner to assess and reconfirm whether any changes in risk profile or CAMEL conclusions have occurred. If a change has occurred, the community bank RAS should be updated and appropriate changes made to the supervisory strategy. At a minimum, the community bank RAS must be updated at the end of the statutory examination cycle. The strategy, along with significant changes to the strategy, should be discussed with bank management. All significant communications and assessments should be recorded in SMS as an "Other/Type 99" analysis, an "Other Significant Event" (OSE), or a "Follow-up/Type 75" analysis.

Communicating

Communication is a critical component of bank supervision. The OCC is committed to continuous, effective communication with the banks that it supervises. Examiners should display and foster a spirit of cooperation in all dealings with bank employees. Communication occurs in the form of formal and informal conversations and meetings, examination reports, and other written materials. All communications should be professional, polite, clear, informative, and consistent.

Communication must be open and continuing throughout the supervision process. Effective communication is a key element to quality supervision. The supervisory strategy for each bank or company must detail plans for communication.

Communication should be tailored to the individual structure and dynamics of each bank. The timing of the communication depends on the situation being

addressed. It is essential that examiners communicate with management and the board as often as required by the bank's condition and the findings from supervisory activities.

Examiners must clearly and concisely communicate significant deficiencies and unwarranted risks to the bank rather than focusing on items that have minimal safety and soundness impact. In situations in which examiners find significant weaknesses or unwarranted risks, examiners should discuss thoroughly these issues with bank management, allowing bank management an opportunity to resolve differences, commit to corrective action, or correct the weakness. The significant issues along with the board's commitment for corrective action should be detailed in the MRBA section of the report of examination (ROE). MRBA are bank practices that:

- Deviate from sound fundamental principles and are likely to result in financial deterioration if not addressed.

- Result in substantive noncompliance with laws.

Weaknesses of a less significant nature may either be addressed as recommendations in the ROE or simply discussed with bank management. In these cases, examiners may recommend enhancements to systems or changes to address those weaknesses. Whether those recommendations are provided in writing or orally, examiners should not request burdensome commitments from management to address them if they do not warrant treatment as MRBA. These non-MRBA recommendations do **not** require followup by OCC personnel or specific implementation by bank management.

Examiners should meet with management often, and directors as needed, to discuss current significant issues about the company. These contacts establish and maintain lines of communication and are an important source of monitoring information. For community banks, this communication is often best done by telephone. All significant communications should be documented in SMS. Typical discussion topics could include:

- Financial performance and trends.

- Issues that management or directors have identified as important to the industry or the company.

- Status of efforts to correct deficiencies.

- Adequacy of management information.

- Potential changes in the risk profile of the company or individual bank, including conclusions from the Risk Assessment System.

- Plans for future supervisory activities.

- Other items of particular relevance since the last examination or communication.

The OCC has set the following minimum standards for specific communications:

Entrance or Planning Meetings with Management

Before the start of each examination the EIC will meet with appropriate company or bank management. At this meeting the EIC will discuss the nature of, reason for, and scope of the review. Open dialogue between the OCC and company management will help to ensure a more efficient and less burdensome examination.

Entrance or planning meetings should:

- Address the focus of the examination including the depth of review for the applicable risk areas.
- Explain how the examiners will conduct the examination.
- Outline how examiners and the bank will communicate during the examination.
- Provide details on the roles of the participating examiners.
- Answer any questions from the bank.

Exit Meetings with Management

At the completion of each examination the EIC will meet with the bank or company's management. At exit meetings the EIC will prioritize the issues identified in the examination and discuss those areas that present the most risk to the bank. Examiners should also discuss conclusions from the risk assessment system and plans for future examinations. Examiners should encourage bankers to respond to OCC concerns, discuss future supervisory plans, provide clarification, and ask questions. At the exit meeting, the examiners will ask for management's commitment to correct all material deficiencies noted during the examination.

Before conducting an exit meeting, the EIC should discuss the significant findings from the examination with the appropriate OCC supervisory office. This discussion helps ensure OCC policy is consistently applied and that OCC

management supports the examiner's conclusions and corrective actions identified as necessary.

Exit meetings are intended to:

- Summarize the nature of, reason for, and scope of the review.

- Discuss OCC conclusions based upon the risk assessment conclusions. The EIC should provide the appropriate supporting detail.

- Discuss potential courses of action to address deficiencies.

- Seek commitments, including time frames, when corrective action is needed.

Examiners must ensure that any significant decisions they reach during this exit meeting are adequately conveyed in the subsequent meeting with the board **and** in the report of examination. Examiners should discuss all material issues with management before they discuss them with the board unless, in the supervisory office's view, the item is best approached confidentially with the board. The tone and content of exit meeting discussions should be consistent in subsequent communications.

Meetings with Board of Directors

A national bank's board of directors is ultimately responsible for the safety and soundness of the bank, and the OCC is committed to helping board members meet that responsibility. Board meetings are intended to maintain effective and ongoing communication with a bank board to discuss OCC examination results and other matters of mutual interest. When necessary, the OCC uses board meetings to outline steps necessary to respond to supervisory concerns and issues.

For **large banks**, the OCC will conduct a meeting with the board of directors and/or an approved committee of the board **at least once during the 12-month examination cycle for the lead national bank**. Such meetings should be more frequent if supervisory concerns are noted. Examiners should not conduct board meetings with non-lead affiliated national banks unless supervisory concerns are significant. Senior supervisory office management should attend and participate in board meetings with large banks.

For **community banks**, the OCC will conduct a meeting with the board or an approved committee of the board at the conclusion of each examination cycle (i.e., at least once during the 12- or 18-month period). The EIC and the field manager or a representative from the supervisory office must attend the board meeting.

At meetings with directors, examiners discuss:

- The objectives of OCC's supervision and how the OCC pursues those objectives.

- Strategic issues including growth, products, and strategies.
- Major concerns or issues, including risks facing the bank.
- The bank's success or failure in correcting previously identified deficiencies.
- The impact of failing to correct deficiencies.
- What the OCC expects the bank to do and when (i.e., action plans, supervisory strategies, and commitments).
- What the bank is doing well.
- Industry issues affecting the bank.

The EIC conducting the meeting should be prepared to discuss methods that bank management may use to correct deficiencies. The board meeting also serves as a good forum for board members to ask questions or comment on various issues. The examiner should be prepared to discuss all supervisory findings, conclusions, and comments. Meetings with the board are an important part of the supervision process and should be conducted with the utmost professionalism.

Reports of Examination

The report of examination (ROE) is the OCC's primary vehicle for communicating examination findings in writing to a bank's board of directors. The ROE is intended to focus the board's attention on the OCC's major examination conclusions, including any significant problems and actions needed to address them. It records the examiner's conclusions and concerns and the actions the bank has committed to take. This record, along with other related correspondence, helps establish and support a bank's supervisory strategy.

A bank's board of directors must receive a summary of condition ROE at least once during the examination cycle. This ROE communicates the activities conducted and conclusions reached during the supervision process. It must contain conclusions on all CAMEL areas and a discussion of significant risks.

Findings from any targeted examinations which help to determine the institution's composite, CAMEL, or specialty ratings must be incorporated into the ROE.

For **large banks**, **examiners must use the uniform common core report of examination to communicate examination findings for all national banks**

over $1 billion. More frequent written communication can be initiated if supervisory concerns warrant. Examiners are not required to use the uniform common core ROE for interim communication; any appropriate form may be used.

The uniform common core ROE is not required for **smaller affiliated national banks.** Communication concerning these affiliates can be in letter form, other ROE style, or the uniform common core ROE format. The communication to the smaller affiliate national banks must address significant findings and conclusions on the individual bank's condition and disclose the bank's composite CAMEL rating.

For **community banks**, examiners must use the uniform common core ROE to communicate the summary of condition ROE. More frequent written communication can be initiated if issues of supervisory concern warrant board attention before the end of the examination cycle. Examiners are not required to use the uniform common ROE for interim communication; any appropriate form of communication can be used.

The OCC strives to provide a high quality and informative ROE to a bank's board of directors. The ROE is written for the board and should clearly, concisely, and effectively communicate significant supervisory issues. The ROE is results-oriented and tells the board what actions, if any, are needed and the reasons for them. All reports must define objectives, state conclusions, and identify any significant problems, corrective actions, commitments, and time frames for correction.

Examination reports must:

- Be consistent with the tone, findings, and conclusions communicated to the bank during the examination.
- Be addressed to the appropriate audience based on how the company is structured and managed.
- Convey the condition of the bank or, if appropriate, an operational unit within the bank.
- Discuss any significant unwarranted risks or significant deficiencies.
- Summarize required actions and commitments to correct deficiencies.
- Be written effectively in a concise manner to ensure issues are understandable.

Documentation

Examiners are responsible for documenting the decisions they make and the conclusions they reach regarding the condition of national banks under their supervision. Supervisory offices must also document actions they take that affect individual national banks. These actions include, but are not limited to, decisions regarding enforcement actions and corporate applications, and other formal communications with a bank.

Documentation may take the form of information in the Supervisory Monitoring System (SMS), working papers, reports of examination, correspondence, or other written records pertaining to a national bank. Documentation should support the statements made in formal communications to a bank (e.g., examination reports, enforcement actions, board meetings, other written correspondence). All documentation must be current, accurate, and reliable.

The amount of documentation supporting decisions and conclusions should reflect the severity of the problems and the complexity of the institution, as well as the nature and extent of the OCC's supervisory concerns. Examiners should not prepare or request information that is not critical to the supervisory process.

Supervisory Monitoring System Entries

SMS is the OCC's electronic bank file. It is the OCC's primary internal source of information about the condition of individual national banks. The OCC uses the system to record the current condition, strategy, and supervisory concerns for each bank. The examiner also uses SMS to document followup actions, board meeting discussions, commitments for corrective action, progress in correcting identified problems, and subsequent events. OCC senior management uses SMS to review the condition of individual banks and groups of banks. Other federal bank regulators also have access to SMS.

SMS is an official record of the OCC. Official records are discoverable items in litigation. Examiners must be cognizant of the language used in SMS and ensure that it is succinct, clear, and highly professional. Examiners should avoid any informalities that might be misunderstood or misused.

Examining Circular 263 establishes OCC policy for updating and maintaining SMS. EICs must maintain SMS in accordance with this policy. The EIC is

responsible for timely and accurate maintenance of SMS. For **community banks**, examiners enter individual bank information under the appropriate charter number. Examiners should record information in **large bank** SMS files as follows:

- Comments pertaining to or affecting the entire company should be recorded in SMS under the holding company charter number. The

company's affiliated national bank files should refer to the holding company charter number for companywide comments.

- Comments particular to a bank should be recorded in SMS under the bank's charter number.

Appeals Process

The OCC seeks to ensure that the supervisory process is administered in a fair and equitable manner. If a disagreement between examiners and the bank arises during the supervisory process, it is OCC policy to resolve the dispute fairly and expeditiously in an informal, amicable manner. When such disagreements cannot be resolved through informal discussions, national banks should, and the examiner involved should specifically encourage the national bank to, seek further review of the OCC decisions or actions.

The OCC examination appeals process is described in the OCC Bulletin 96-18, "National Bank Appeals Process – Guidance for Bankers." As part of the OCC's appeals process, the OCC established the position of ombudsman. The ombudsman position is outside the bank supervision area and reports directly to the Comptroller of the Currency. The ombudsman has the discretion to supersede any agency decision or action during the resolution of an appealable manner subject to an override by the Comptroller. National banks are encouraged to use the ombudsman.

Quality Assurance

The OCC has a quality assurance process that is designed to ensure the OCC has consistent, high quality bank supervision. Recognizing that community banks and large banks have somewhat different focuses, the OCC has two programs of bank supervision, one for community banks and one for large banks. Both programs support and promote the efficient supervision of the national banking system. The OCC's quality assurance programs incorporate both ongoing quality control processes, which ensure work products are in compliance with established procedures and policies, and an after-the-fact review of material to assess the effectiveness of these policies and procedures.

OCC's quality assurance programs are not a reexamination of the bank; rather, they seek to ensure that the conclusions reached by the examiner, and conveyed to the bank, are in compliance with OCC policy, are reasonable under the circumstances, and are supported by the information available to the examiner. Quality assurance covers all aspects of bank supervision including the development of strategies; the examination itself, which includes safety and soundness activities and specialty areas; communication with bank management and directors; and an assessment of the actions required of the bank.

References

Laws

Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) 12 U.S.C. 1820(d)

Riegle Community Development and Regulatory Improvement Act of 1994 (Riegle Act)

OCC Issuances

Examining Circular 159, Supplement 1, Uniform Interagency Rating System
Examining Circular 261, Interagency EDP Examination Scheduling, and Report Distribution Policy

OCC 95-5, Multiregional Data Processing Services
OCC 95-24, Community Reinvestment Act Final Rule
OCC 95-30, Compliance Examination Cycle
OCC 96-18, National Bank Appeals Process – Guidance for Bankers

PPM 5100-2, Shared National Credit Program
PPM 5130-1 (Revised), Supervision of Federal Branches and Agencies
PPM 5200-1, New Compliance Program
PPM 5300-1, Bank Information Systems Program
PPM 5310-3 (Revised), Policy for Taking Corrective Action
PPM 6000-5, OCC Documents

The Comptroller's Handbook, "Community Bank Consumer Compliance"
The Comptroller's Handbook, "Community Bank Procedures for Noncomplex Banks"
The Comptroller's Handbook, "Community Bank Risk Assessment System"
The Comptroller's Handbook, "Examination Planning and Control"
The Comptroller's Handbook, "Large Bank Supervision"