INTRODUCTION

The Thrift Activities Regulatory Handbook is a "how to" manual to aid the Office of Thrift Supervision (OTS) regulatory staff and the savings and loan industry in the regulatory process. It is intended to address examination and supervisory issues.

This introductory section explains how to use the Regulatory Handbook in the examination process, describes the organization of the Handbook chapters and sections, and sets forth objectives and procedures common to all phases of the examination.

The Handbook is a guide for the examination of savings associations regulated by the OTS. It provides regulatory personnel with uniform standards for planning and conducting examinations and should be used as a reference tool, a training aid, and a guide to national policy and procedure.

The Handbook illustrates and describes, for the benefit of the OTS regulatory staff and the industry, certain standards of conduct and prudent operation that the OTS views as important to the safe and sound operation of savings associations, consistent with the respective fiduciary duties of those individuals who are associated with them.

Through the regulatory process, agency personnel assess an institution's degree of safety and soundness, objectively evaluate its condition, report their findings, inform boards of directors of institution strengths and weaknesses, and facilitate corrective action where needed. To be most effective, the regulatory process should not only identify existing regulatory violations, but also identify potential problems, prevent the development or continuation of unsafe operating practices, effect the timely resolution of problems, and identify strengths of the institution. Proactive regulatory supervision that evaluates future needs and potential risks helps to ensure the success of the thrift system in the long term. The Handbook provides a framework for the successful completion of this process.

The Handbook is designed to encourage independent reasoning, objectivity, efficiency, and professionalism in the examination process. To promote consistent application among the five OTS regional offices, the Handbook sets forth national minimum standards for examination objectives and procedures. While this promotes standardization of the examination process, regulators are encouraged to modify programs to fit specific institution needs.

The Handbook is designed for use by both new and experienced regulatory personnel. Background information, applicable references, and expanded procedures are included to serve as "memory joggers" and to facilitate the learning process.

The regulator should supplement use of the Thrift Activities Regulatory Handbook and associated programs with education, experience, and judgment. Supplemental pages, updates, and revisions to the Handbook will be published and distributed periodically. Separate manuals are also available concerning: Holding Companies, Trust Activities, Compliance Activities, Information Services (IS), and Application Processing.

References to specific sections of regulations within the text refer to all regulations promulgated by OTS unless otherwise designated. Those regulations authorized by other regulatory agencies will be identified by the following standard acronyms:

- OCC Office of Comptroller of the Currency
- FDIC Federal Deposit Insurance Corporation
- FRB Federal Reserve Board

HANDBOOK ORGANIZATION: CHAPTERS

The Handbook contains a table of contents and 8 chapters; a chapter on the administration of the regulatory process; a chapter on each of the six areas of the examination, i.e., Capital Adequacy, Asset Quality, Management/Administration, Earnings, Liquidity, and Sensitivity to Market Risk (CAMELS); and a chapter that includes mortgage banking and other thrift activities. The Handbook also includes a Glossary.

Table of Contents

The table of contents lists each Handbook chapter, section number and title, and, if applicable, appendices and questionnaires.

000 Administration

This chapter gives a general overview of the administration and coordination of the regulatory process. The chapter includes instructions on determining the scope of an examination, discusses monitoring and the regulatory plan process, and provides guidance on assigning component and composite CAMELS ratings and examination strategy.

100 Capital Adequacy

This chapter provides useful information for assessing whether an institution's capital position is sufficient, given the institution's level of risk, to meet the institution's needs and to ensure its ongoing viability. The chapter, which includes topics such as minimum regulatory capital requirements, prompt corrective action (PCA) categories, and stock ownership and control, will assist examiners in determining the adequacy and composition of an institution's capital.

200 Asset Quality

This chapter addresses two issues: (1) the determination of risks related to the institution's assets and (2) the institution's management, administration, and evaluation of the quality of these assets. The chapter will assist regulators in assessing credit risk and reviewing asset portfolios (including loans, investments, and other assets). This chapter focuses on the quality of an institution's loan and investment underwriting and portfolio management, affirmation of the level of classified assets, and adequacy of valuation allowances. Sections discussing real estate appraisals, loan sampling, the Qualified Thrift Lender Test, and Margin Securities (Regulation G) are also included.

300 Management/Administration

This chapter provides guidance in evaluating the capability of executive management and the board of directors and includes a checklist of the board of directors major responsibilities. The chapter also covers objectives, procedures, and references for examining internal controls, internal and independent audits, fraud and insider abuse, and enforcement actions. A section on planning meetings with the board of directors is also included.

400 Earnings

This chapter provides direction for the analysis of an institution's financial condition. This chapter covers objectives, procedures, and references for examining the institution's financial recordkeeping and reporting methods and operations analysis. This chapter also discusses present value analysis.

500 Liquidity

This chapter provides assistance in assessing liquidity and the funding risk confronting an institution. The chapter includes material on funding and cash flow management, and investment activities. The Government Securities Act, Payments Systems Risk, and Regulation D are also discussed.

600 Sensitivity to Market Risk

This chapter provides assistance in assessing the market risk confronting an institution. The chapter includes guidance on interest rate risk management, hedging, and off-balance sheet derivative instruments.

700 Other Activities

This chapter provides guidance in the evaluation of risk that operating subsidiaries, service corporations, and lower-tier entities (such as joint ventures or limited partnerships) pose to the institution and thereby the insurance fund.

This chapter also addresses activities in which the thrift and subordinate organizations may be involved: mortgage banking, insurance, and non-deposit investment sales.

800 Glossary

The glossary contains an alphabetical list of terms and definitions specific to the examination process. Definitions of frequently used terms may also appear within individual handbook sections.

CHAPTER ORGANIZATION: SECTIONS

Within each chapter, examination materials are subdivided into sections by different areas of review. Each Handbook chapter contains several sections. For example, Chapter 300 contains a section for each area of review under Management.

To allow for easy identification and referencing of materials, each handbook section has a unique three-digit number. Within Management Chapter 300, the section on Oversight by the Board of Directors is number 310. Each handbook section, and any corresponding program, questionnaire, and work paper, is assigned the same number. Handbook pages are numbered in accordance with the section; hence, the introduction for Oversight by the Board of Directors, Section 310, is Handbook page number 310.1.

Each handbook section contains an introduction, examination objectives, procedures, regulatory references, related questionnaires, and appendices. These components are briefly discussed below. This discussion also includes a list of common objectives and procedures which, though perhaps not included in a particular handbook section or program, may be of value to the regulator in successfully conducting an examination.

Introduction

The introduction provides the reader with basic information such as OTS policy and pertinent accounting issues. Significant concerns are highlighted, including the nature and intent of enforcement actions that may be applicable to the area. Subheadings are used as appropriate.

Examination Objectives

This segment identifies the goals toward which the regulator is striving while conducting a review of the subject area. Objectives are presented in each handbook section and on the corresponding program, if applicable, for easy reference.

Certain objectives are germane to the overall examination process and to virtually every examination section. These common objectives, essential to the overall examination process, are presented below. Regulatory staff may wish to review this list during the course of an examination, as these objectives might not be specifically included in other handbook sections.

Common Objectives

- Document the effectiveness of an institution's operations.
- Determine compliance with laws and regulations.
- Determine the adequacy of and adherence to institution policies and procedures.
- Assess management's expertise and ability to manage the institution's affairs.
- Assess the board of directors' oversight and ensure that management and the board are receiving complete and accurate reports.
- Verify that an acceptable system of records and internal controls is in place.
- Assess the effect of anticipated internal and external changes on the institution.

- Assess the institution's ability to meet its future needs (e.g., fund growth, provide capital, absorb losses).
- Identify any actual or potential undue risk to the institution.
- Report examination findings:
  - — Present analysis and conclusions regarding the institution's overall condition, trends, and prospects for future viability.
  - — Report concerns of material risk and initiate corrective action when needed.

Examination Procedures

Procedures that the regulator should follow to achieve the objectives for each area of review are set forth in the handbook sections. Although circumstances may dictate some variation, the following steps will lead to an efficient conclusion for each area of review.

The procedures are divided into three groups: Levels I, II, and III. Level I procedures are basic to an analysis of a thrift's operations. Many of the general procedures enumerated in this section (010) are Level I procedures. There are also expanded procedures set forth in Levels II and III.

Level II procedures are usually used to test the conclusions drawn from the review of policies, procedures, skills, and organizational structures covered by Level I procedures. Although regulators often use Level II procedures, the extent of their use is left to the discretion of the regulator and regional office policy.

Level III procedures are even more discretionary. Regulators should follow these procedures only when they identify significant problems and it is necessary and expeditious to perform audit-like verification procedures. Level III procedures demonstrate the full spectrum of potential examination procedures.

Although examination subject areas differ greatly, certain procedures are applicable to any phase of an examination. A list of procedures that are common to the overall examination process and to virtually every examination section appears below. The regulator may wish to review this list when completing an area of review, as the procedures might not be specifically incorporated in other handbook sections or programs.

General Procedures

<u>Gather Data</u>

- Review previous Report of Examination (ROE), PERK documents, exceptions, and work papers
- Review current year's scope, supervisory correspondence, and interagency data
- Consider regulatory policy associated with area of review
- Set forth special considerations pertinent to the areas of examination
- Obtain institution's management reports and written policies and procedures.

<u>Set Scope (see also Handbook Section 060)</u>

- Establish a clear understanding of examination objectives
- Perform analytical review procedures on financial data:
  - — Identify new or unusual transactions requiring modified examination procedures
  - — Indicate areas of greatest concern
- Tailor examination program to meet individual needs
- Consult with other regulators; take the nature of their initial findings into account in determining the procedures to perform
- Determine if expanded procedures are necessary
- Develop additional procedures not covered in the Handbook, if necessary
- Perform only those procedures necessary to achieve program objectives.

Perform Procedures

- Interview institution personnel
- Evaluate policies and procedures
- Spot check the reliability and accuracy of reports
- Test the institution's procedures
- Identify material changes in operation or policy since previous examination
- Evaluate trends
- Research significant variations from last year's examination to determine if there is cause for concern
- Obtain explanations for any matters of significance.

Assess Management

- Review adequacy of management reports to the board of directors
- Determine the extent to which the directors are involved in monitoring performance
- Review management's plan for future operations
- Interview management and staff to ascertain if personnel have adequate knowledge of policies and procedures
- Determine sufficiency of training and expertise to implement procedures
- Determine if policies and procedures are being communicated and regularly updated.

Formulate Conclusion

- Keep the examiner in charge (EIC) informed of progress
- Discuss concerns with other regulators
- Identify, and determine significance of, regulatory violations and deficiencies
- Discuss findings with management
- Determine adequacy of management's response to problem issues
- Consider possible strategies for corrective action and develop recommended course of action.

Conduct Postreview Activities

- Review work to ensure objectives have been satisfied
- Summarize results and conclusions
- Draft comments, including scope and recommendations
- Assign ratings if applicable
- Ensure that there are properly cross-referenced work papers to document and support substantive findings and conclusions
- Update the Continuing Examination File (CEF), if applicable (see Handbook Section 060)
- File exceptions in the General File (GF).

References

Pertinent legislative and regulatory citations appear in the reference section. References to other relevant OTS issuances are identified where appropriate, including: various bulletins, agency instruction and class manuals, industry sources, and accounting pronouncements.

The reference list is purposefully comprehensive, providing resources beyond those needed on a day-to-day basis. Therefore, a regulator should not be concerned if access to these references is not routinely available. If the institution under examination is state chartered, the regulator should also refer to state regulations in accordance with regional office policy. Regulatory references appear in the applicable handbook section and on the companion program.

Questionnaires

Questionnaires appear at the end of some handbook sections. The questionnaires are free-standing, so that they may be photocopied for use in an examination, if necessary.

General Questionnaires—General questionnaires reflect standards for safe and sound operating procedures and may be useful for evaluating an institution's operations. These questionnaires also include questions on internal controls that, for objectivity, regulatory staff must answer. They also assist in organization, act as memory joggers, and facilitate the review process.

It is not necessary to complete all questionnaires. The regulator should include only those questionnaires pertaining to the examination scope and objectives.

Procedural Questionnaire—This questionnaire is included in the Thrift Activities Regulatory Handbook Section 340, Internal Controls, as well as in the Preliminary Examination Response Kit (PERK). The Procedural Questionnaire contains questions about the institution's internal controls. The institution should complete this questionnaire prior to the examination and regulatory staff should verify the institution's answers on-site.

Appendices

The Appendices present additional sources of information, including available forms and guidelines.

INTRODUCTION

The examination program serves as a guide for the orderly completion of an examination. This Handbook Section offers information on program use, gives an overview of the program format, sets forth procedures for documenting work papers, and lists sources of information that may be useful during the examination process.

Programs supply the regulator with objectives for the review of a subject and a series of procedures for completing those objectives. Examination programs also help determine the examination scope and organization, serve as documentation, and help establish conclusions and recommendations. Once completed, the program becomes part of the foundation for an effective quality review process.

Each program corresponds to a handbook section for the examination process. Each handbook section contains a discussion of the subject area, examination objectives, examination procedures, questionnaires, and pertinent appendices, if any.

PROGRAM ORGANIZATION

Examination programs mirror the format of a portion of their corresponding handbook section. Each program includes examination objectives and procedures, a summary section, and regulatory references. Space is provided for conclusions, recommendations for corrective action (if necessary), and other comments. An index block is also provided so that the regulator may index the program to the corresponding work papers. Each of the program segments is described briefly below.

Examination Objectives

Objectives listed on each program refer to specific areas of review. Handbook Section 010, Handbook Use, also presents and discusses some common objectives the regulator should be aware of throughout the examination process.

Examination Procedures

Examination procedures are organized in a top-down fashion and are divided into three groups, each representing a different level or depth of review: Levels I, II, and III. The top-down approach begins with a review of policies, procedures, and internal controls while focusing on the safety and soundness of the institution (Level I). With this approach, regulatory personnel can expeditiously assess the degree of risk in each area of a particular institution's operations early in the examination and determine the depth of review and the procedures (Levels II and III) needed.

The programs are intended to serve as guides and reminders for the regulator. Less experienced regulators will find the programs especially useful as guides for the effective completion of assigned phases of examinations. More experienced regulators will tend to use the programs as reminders of what is expected to be reviewed within each phase of an examination.

Handbook Section 010 contains a list of general procedures for all facets of the examination not necessarily included in individual programs, with which the regulator should be familiar.

Not all programs will be applicable to an institution. Further, of those programs that are used for a particular examination, not all procedures will be needed. The examination scope should help determine the level of review and procedures needed in each area. See Handbook Section 060, Examination Strategy, Management, and Scoping. When selecting programs and procedures for review, the regulator must ensure that procedures are sufficient to: (1) address the concerns in the scope and any other problems found during the review, (2) assess the safety and soundness of the institution, and (3) update and support the CAMELS composite and component ratings.

When using this risk-based examination approach, the regulator should use sound professional judgment to ensure that the depth of review is sufficient to accurately assess the institution's condition, but is not excessive. Following is a discussion of the three levels of procedures and the national policy guidelines for their use.

Level I

Level I procedures focus on the review of examination scoping materials and institution documents, such as policies and procedures. The Level I review is followed by interviews with personnel to determine if practices conform to written guidelines and to confirm any other preliminary findings.

If significant items of concern are uncovered during Level I analysis, or if significant problems were identified during the pre-examination monitoring and scoping, the regulator may need to use Level II procedures. In certain circumstances, the regulator may need to complete Level III procedures as well.

Level II

Level II procedures focus on the analysis of institution documents such as loan files, management reports, and supporting financial records. The regulator should select and complete Level II procedures when Level I procedures do not reveal adequate data on which to base a conclusion for an area of review. Regulators may develop an independent analysis of asset values at this level as well as independent verification of other items.

Level I and selected Level II procedures normally provide a comprehensive analysis from which conclusions can be drawn, but do not include any significant auditing procedures. If the regulator cannot rely on the data contained in institution records, Level III procedures may be necessary.

Level III

Level III procedures include steps that auditors usually perform. Although certain situations may require Level III procedures, it is not standard practice of Office of Thrift Supervision (OTS) regulatory staff to duplicate the testing efforts of auditors.

Again, it may not be necessary to complete every program or every procedure within a program. The regulator must use discretion in determining which programs and procedures are necessary to address the scope and reach a sound conclusion. In some situations it may be appropriate to customize existing procedures or to perform procedures that are not listed within a program in order to achieve the most efficient and meaningful analysis. The regulator should document any decisions to deviate significantly from the initial scope instructions or to modify existing procedures on the relevant programs.

Programs and Work Papers

Properly prepared examination work papers are essential to the examination process. They are relied upon to support the conclusions and findings set forth in the report of examination (ROE). Conclusions regarding the effectiveness of the OTS examination process may be determined, in part, by the adequacy of work paper documentation. Proper documentation of procedures and subsequent conclusions leaves an effective audit trail for users of the completed programs. More-over, examination work papers are often used by legal staff to support the OTS' position in litigation matters.

The programs allow space to the right of each procedure to record a work paper cross-reference that indicates where supporting documentation is found whether under the same topic or contained in another program. All substantive conclusions must be supported. Additional space between each procedure allows the regulator to include any pertinent information.

For those examination programs and procedures deemed unnecessary, you should include a notation, i.e., "N/A," "not required by scope," or other explanation, either on the index or on the program itself, as appropriate.

The following items are examples of information that should be included in work papers and programs, as appropriate:

- Statement of purpose, title, or heading
- Scope of review
- Procedures used
- Legend or explanatory footnotes, if necessary
- Results of testing
- All substantive conclusions
- Sources of information, including names or titles of institution contact personnel
- Identification of regulator performing the procedure
- Identification of person completing the review
- Institution name and location
- Institution docket number
- Examination date
- File index number
- Cross-references, where needed.

Regulator Summary, Recommendations, and Comments

The regulator should complete this portion of the program in narrative form, summarizing the following:

- Examination scope, including identification of any procedures used that are not already printed on the program.
- Salient findings as well as a conclusion regarding the strengths and weaknesses of the institution's operations in the particular area of review.
- Recommendations for corrective action, which may include a statement about the adequacy of management's response and commitments. (Note: The regulator should address any recommendation for revision of a formal supervisory action in a separate memorandum.)

The regulator may attach continuation pages for any additional comments. The regulator should support in the work papers all substantive findings regarding the overall condition of the institution. It may be useful to attach copies of draft comments or schedules included in the ROE to this portion of the program.

Regulatory References

This segment contains a list of pertinent legislative and regulatory citations. References to relevant documents and industry sources are also identified where appropriate. If the institution under review is state chartered, the regulator should refer to appropriate state legislation.

The companion handbook section contains an identical list of references.

Index Block

The title of each program is centered in the top and bottom margins. The lower right-hand corner contains an index block for the following items: Examination Date, Prepared By, Reviewed By, and Docket Number. The regulator should fill in each of these items before completing the examination.

File work papers according to the OTS program number. To locate examination programs easily, the regulator may use the Handbook table of contents or the program index as a cover page for file folders. Information germane to the ROE or review process should be cross-referenced to supporting documentation.

SOURCES OF INFORMATION

Following is a generic list of information sources that may be helpful in successfully completing the programs.

OTS documents:

- Laws and regulations
- Standard and supplemental accounting manuals
- Published memos
- OTS Training and Development materials

- Uniform Thrift Performance Report (UTPR)

Regional office examination materials:

- Previous ROEs, General File, and work papers
- Correspondence from the regional office
- Continuing Examination File (CEF), if applicable
- Thrift Financial Reports (TFRs)
- Regional office instructional manuals

Institution's documentation:

- Completed Preliminary Examination Response Kit (PERK) schedules
- Business plan
- Operating budget and forecasts
- General ledger trial balance
- Loan trial balance
- Investment trial balance

Reports and minutes:

- Independent audit report
- Internal audit report
- Internal management and board reports
- Securities and Exchange Commission (SEC) annual report, 10K, 10Q, and 8K (if stock institution)
- Board of directors' minutes
- Board committee minutes
- Operating committee minutes

New or revised policies, procedures, and corporate documents:

- Real estate lending policies
- Real estate appraisal policy
- Environmental risk policy
- Classification of assets policy
- Investment policies
- Interest rate risk policy
- Asset/liability management policy
- Interbank liabilities policy
- Futures and options policy
- Charter, bylaws
- Security policy
- Currency and Foreign Transactions Reporting Act (CFTRA) policy
- Community Reinvestment Act (CRA) statement
- Contracts (information systems, service bureau, employment, etc.)
- Contingency planning policy
- Leases (office building, etc.)
- Payments systems risk policy

INTRODUCTION

This Handbook Section summarizes and discusses some of the more important rules and policies of professional conduct that apply to OTS personnel, including examiners, while performing on-site examinations. For purposes of this Handbook Section, we define "you" as OTS personnel.

All OTS employees must comply with the OTS Employee Standards of Conduct Resource Guide (Resource Guide) that contains the following federal regulations:

- Standards of Ethical Conduct for Employees of the Executive Branch (5 CFR Part 2635, §§ 2635.101-902).
- Employee Responsibilities and Conduct (5 CFR Part 735, §§ 735.101-203; p. 79).
- Department of the Treasury Employee Rules of Conduct (31 CFR Part 0, §§ 0.101-217; Appendix 2).
- Supplemental Standards of Ethical Conduct for Employees of the Department of the Treasury (5 CFR Part 3101, §§ 3101.101-104, 109; Appendix 3).

Additionally, financial restrictions and required disclosures apply to "covered" OTS employees, defined by 5 CFR § 3101.109(a) as examiners, employees in grades 17 and above, and any other OTS employee designated by the Director.

Each employee receives the Resource Guide. If you have any questions about the regulations, contact your regional ethics counselor or the OTS Ethics Counselor at (202) 906-7039.

Summary of Major Restrictions and Responsibilities of OTS Employees

This summary of the important OTS restrictions and responsibilities comes from the above federal regulations and OTS policies. It is not all-inclusive. As an OTS employee you need to be aware of your responsibilities, restrictions, and disclosure requirements under these rules. If you need or desire further information, you may contact your regional ethics counselor or the OTS Ethics Counselor.

All OTS Employees

All OTS employees must comply with the following restrictions:

- You may not have any financial interest or obligation that conflicts or appears to conflict with your official responsibilities and duties.
- You may not, in an official capacity, participate personally and substantially in any particular matter in which you have a financial interest if the matter will have a direct and predictable effect on that financial interest. (However, the Chief Counsel, Regional Director, or designee may, when appropriate, waive this restriction.) You may not participate by decision, approval, disapproval, recommendation, advice, examination, or other action. This restriction also applies where any household member, general partner, or organization in which you have a substantial personal involvement has a known financial interest in the matter.
- You may not accept from a prohibited source (defined below) food, refreshments, or entertainment unless it is of a nominal value. You may only accept a nominal value item infrequently, such as during an official conference or other function that you may properly attend.
- You may not accept unsolicited advertising or promotional material if its retail value exceeds $20. You must return items exceeding this value to the sender or dispose of them as directed by the Chief Counsel (or designee) or your ethics counselor.
- You must receive prior supervisory approval before speaking about OTS or publishing OTS-related material for a nonagency audience.

- You may not engage in any outside employment or business activity, paid or unpaid, without prior written supervisory permission from the Deputy Director, Managing Director, Regional Director, or Chief Counsel.
- You may not directly or indirectly make recommendations or suggestions concerning the acquisition, sale, or other divestiture of securities of any OTS-regulated savings association or savings association holding company.
- You may not purchase property owned by the government and under the control of OTS, or sold under the direction or incident to the functions of OTS, without an appropriate waiver.
- You may not have communications with a thrift, its holding company, or affiliates suggesting either of the following:
  - — That the examination process is in any way influenced by political issues or considerations.
  - — That either the thrift, its holding company, or affiliates should take a particular position on political or legislative issues.

You must notify your supervisor or ethics counselor if you are aware of any communications that might conflict with or compromise either of these restrictions.

<u>Definition of Prohibited Source</u>

The term "prohibited source" (as used in this Handbook Section) means any person, or entity, who meets any one of the following criteria:

- Seeks official action by OTS.
- Does, or seeks to do, business with OTS.
- Conducts activities regulated by OTS.
- Has interests that may be substantially affected by the performance or nonperformance of your official OTS duties.
- Is an organization with a majority of members who fall within any of the above classifications.

Covered OTS Employees

If you are a covered OTS employee, you must comply with the following restrictions and disclosure requirement(s):

- You (or your spouse or minor child) may not knowingly accept or become obligated on, directly or indirectly, any impermissible extension of credit from an OTS-regulated savings association or its subsidiary. However, you (or your spouse or minor child) may obtain a credit card from an OTS-regulated savings association or its subsidiary with certain limitations:

  Nonexaminers

  - — The terms and conditions are no more favorable than those offered to the public.

  Examiners

  - — The association is not headquartered in your region.
  - — You are not assigned to examine the association.
  - — The terms and conditions are no more favorable than those offered to the public.
  - — You must file a written statement disqualifying yourself from examining the association. (You may still participate in other supervisory matters involving the institution.

(For limited exceptions, refer to Supplemental Standards 5 CFR § 3101.109(c).)

- You (or your spouse or minor child) may not purchase any <u>asset</u> from a savings association or its affiliate, including an institution in receivership or conservatorship. (For limited exceptions, refer to Supplemental Standards § 3101.109(f).)
- You (or your spouse or minor child) may not purchase, own, or control, directly or indirectly, any <u>security</u> of an OTS-regulated savings association and most savings association holding companies. (For limited exceptions, refer to Supplemental Standards § 3101.109(b).)

- You must file required financial disclosures as described below.

Financial Disclosure

Employees in Grade 27 or below must file the annual financial disclosure form(s) by October 31 of each year. If you are an employee in Grade 28 or higher, you must file your forms by May 15 of each year.

- If you are an employee in Grades 17 through 20, or an examiner in Grades 20 or below, you must file an OTS Confidential Financial Disclosure Form (OTS 1569A).
- If you are an employee in Grades 21 through 27, you must file an Executive Branch Personnel Confidential Disclosure Report (OGE 450 or 450A).
- If you are an employee in Grade 28 or above, you must file an Executive Branch Personnel Public Financial Disclosure Report (SF 278).
- If you are an employee in Grade 21 or higher, you also must file a Confidential OTS Supplemental Financial Disclosure Form (OTS 1569).

Except for the SF 278, which is public, financial disclosure is confidential. The Privacy Act (5 USC §552a) governs disclosures of reported information. Authorized OTS, Treasury Department, and certain other officials use the information for the following reasons:

- To ensure ethical conduct.
- To prevent conflicts of interest.
- To monitor compliance with the Standards of Ethical Conduct for Employees of the Executive Branch regulations.
- To monitor the prohibitions on loans to and investments by covered OTS employees (5 CFR § 3101.109 (b) and (c)).

The disclosures also permit regions to schedule assignments so that no OTS employee will examine, supervise, or participate in decisions involving a savings association or savings association subsidiary that has taken any of the following actions:

- Extended credit to the OTS employee.[1]
- Employs a relative (especially in a policy-making position).
- Opened employment contacts, as discussed below.

Negotiations for Employment

As an OTS employee you should not negotiate or have any arrangement concerning prospective employment with any person or organization while simultaneously representing OTS in any particular matter that affects the person or the organization. Under 18 USC § 208(a), such negotiations or arrangement may be a crime.

Concerning job offers, you must immediately inform your supervisor of offers of employment in either of the following circumstances:

- If you do not unconditionally and immediately reject the offer from a savings association or other prohibited source.
- The region has assigned, or you believe it is likely the region will assign, you to examine, supervise, or make any regulatory decision affecting that prohibited source.

Your supervisor and/or ethics counselor must decide if you should provide an employment restriction (recusal) to eliminate any potential conflict of interest. Recusal from any current assignment(s) should last until you resign or send a written rejection of the employment offer. Outright and immediate rejection of unsolicited offers requires no recusal, but a memorandum to the file or to your supervisor is advisable.

An OTS employee rejected for a job by a prohibited source should generally refrain from participating in OTS matters relating to the poten-

[1] Rules governing the conduct of OTS personnel prohibit covered OTS employees from obtaining new credit from savings associations or savings association subsidiaries. Employees with credit outstanding as of April 30, 1991, are grandfathered, provided they are repaying the debt according to the original terms of the note or the loan agreement.

tial employer for at least one year. However, a written review of the matter by an OTS ethics official recommending an exception, may permit earlier participation by the employee.

PROFESSIONAL CONDUCT IN INSTITUTIONS

The following presents professional conduct guidelines that address some issues that examiners may face in their day-to-day work in institutions.

Duration of Onsite Examinations

Examiners should conduct each examination in the most efficient and least disruptive manner possible, to limit the time spent on site at each institution. To this end, you should thoroughly scope and plan each examination, targeting problem and high-risk areas.

Preexamination activities should include contacting the institution's management and obtaining lists of employees and documents necessary to perform the examination.

Working Hours

EICs should manage time in a responsible and professional manner. The examination staff conducts examinations on an Alternative Work Schedule (AWS). This allows for eight nine-hour days, one eight-hour day, and one day off during each two-week pay period.

Examiners should obtain approval from the EIC for deviations from normal working hours during an examination and should explain to the EIC the reason for all absences not preapproved. Also, the EIC should inform the institution's management of any unusual variances, especially absences, from the normal work schedule. Absences without notice give the impression of lack of responsibility and care.

Working Space

Savings associations should provide adequate working space for examiners. If space is inadequate, examiners may request additional or other space as long as its use does not unreasonably disrupt association operations.

To avoid any appearance of impropriety, when you are working in an institution you should take the following precautions:

- Ensure that a representative of the institution is on the premises whenever you are working.
- Not accept keys to the institution's offices or assume responsibility for its property.
- Not enter places where there is a possibility of access to cash or other negotiable instruments unless a representative of the institution accompanies you.

Access to Information

When you are in an institution you must take care to adhere to the following procedures:

- Carefully protect all information an institution entrusts to you and secure it from unauthorized access.
- Never leave confidential documents unattended; you should lock them up when not in use.
- Never divulge confidential information in any form to unauthorized persons.
- Never leave computers unattended in the following circumstances:
  - — While logged onto an OTS system.
  - — While the computer is in a status that would allow unauthorized access to an OTS system or to any confidential data stored on diskettes or disk drives.

You should notify the EIC or other supervisors if the institution refuses to provide you with any information needed to conduct an examination.

Breaks

The EIC will determine the propriety, times, and lengths of breaks.

Lunches

You may use an institution's dining facilities if the institution invites you to do so and you pay for your own meals. Examiners on assignments with large crews should stagger their lunch breaks so that the entire crew is not absent from the work place simultaneously.

Professional Decorum

The following guidelines are general prescriptions for interacting with other regulators and institution employees during an examination.

- You should limit unnecessary conversations with other regulators and the institution's employees.
- You should treat institution employees in a courteous, friendly, yet businesslike manner.
- You should not discuss work with unauthorized employees. You should generally confer with the EIC before discussing anything other than routine matters with employees or management.

Smoking

OTS employees who smoke should always be courteous and considerate of others, and should follow any institution rules regarding smoking.

Telephone Calls

You should limit telephone usage, even for official matters. You should avoid personal telephone calls unless they are absolutely necessary.

Parking

You may use an institution's private parking facilities if invited to do so by the institution. The EIC must, however, approve such use, which should not unduly inconvenience employees or customers.

If the institution uses an independent parking facility, you may not park there at the institution's expense.

Travel Expenses

All travel, lodging, and subsistence expenses incurred while on official duty shall be paid for or reimbursed only by OTS. For further information regarding reimbursement for travel and lodging refer to OTS's National Travel Policy manual.

Business Attire

You should wear appropriate business attire at an institution. Standards of appropriateness may vary depending on regional policy, the institution, and the customs of the community.

REFERENCES

See The OTS Employee Ethics and Standards of Conduct Resource Guide.

United States Code (18 USC)

Chapter 11 §§ 201-219 (Appendix 14)	Bribery, Graft, and Conflicts of Interest

Code of Federal Regulations (5 CFR)

Part 2635 §§ 2635.101-902	Standards of Ethical Conduct for Employees of the Executive Branch
Part 735 §§ 735.101-203 (p. 79)	Employee Responsibilities and Conduct
Part 3101 §§ 3101.101-104, 109 (Appendix 3)	Supplemental Standards of Ethical Conduct for Employees of the Department of the Treasury

Code of Federal Regulations (31 CFR)

Part 0 §§0.101-217 (Appendix 2)	Department of the Treasury Employee Rules of Conduct

INTRODUCTION

EDS refers to the Examination Data System (EDS) which captures basic data from an institution's examination and maintains it on a central data base in Washington. The ROE or Report of Examination system stores the ROE as a text file in the EDS data base.

Information from both EDS/ROE can be easily accessed in the Thrift Information Management (TIM) system. TIM allows ready access to standard reports for individual institutions or groups of institutions grouped by docket file, specific caseload, state, subregion, region, or all regions.

The Examination Data System

The EDS is composed of four parts (I, II, III, and IV) which are accessed throughout the examination process.

EDS Part I: Examination Commencement Data

The official examination start date is recorded in EDS I anytime from when an examination is scheduled until the day the on-site examination work begins. For on-site examinations, the start date is always the day that examiners begin on-site work. On-site work includes examination procedures performed by examiners while on the subject institution's premises, courthouse, building site, real estate office, or other location outside of an OTS office.

For off-site examinations, the start date is always the day that examiners begin off-site work. Off-site work includes examination procedures performed by examiners while in an OTS office. For off-site examinations, EDS Part I is entered the day office work begins. The system allows future dates to be entered as examinations are scheduled and planned. Upon data entry, EDS I is transmitted to Washington and the data is available in TIM reports. EDS I also records the examination type.

<u>Types of Examinations</u>

Following is a list of the nine types of thrift safety and soundness examinations:

Code	Type
10	Federal Regular
11	State
20	On-site Supplemental
21	Off-site Supplemental*
22	Off-site Monitoring
23	Year 2000 (Y2K)
30	Eligibility
40	Special Limited
50	Field Visit

* Off-site and supplemental Y2K beginning 1997

All examination types, except state examinations, may be joint examinations with other regulators. Special limited examinations include all Capital, Assets, Management, Earnings, Liquidity, and Sensitivity to Market Risk (CAMELS) pages, but may have "no comment, not examined" entered instead of a comment. There are various ROE packages for the various examination types.

<u>Types of Examination Packages</u>

The ROE document is created from a personal computer (PC) client-server application designed specifically for the examination process. The examiners identify the pages pertinent to the examination and the application assembles the latest version of the ROE documents, populates the financial data, and downloads the assembled document to the examiner's PC. The ROE document can be uploaded with additional pages throughout the examination process. Two types of safety and soundness ROE shells are available. They are the full ROE and the memo-style ROE. There is also a year 2000 ROE.

Full ROE

The full ROE is required for all thrift regular, eligibility, and special limited examinations. The ROE consists of mandatory and optional supplementary pages. The mandatory pages are generally based on the October 1, 1993 Common Core report of examination adopted by the four federal financial institution regulatory agencies.

The CAMELS pages contain analysis and comments. The optional pages contain various schedules, financial data, and statistical data used to support the analysis. The type and scope of an examination dictates which optional supplementary pages are required. Examiners are encouraged to use only ROE pages that are useful in presenting examination findings.

Memo-Style ROE

The memo-style ROE is just that, a memorandum, and is used for field visits, supplemental, and monitoring examinations. Any of the ROE pages can be attached to the memo-style report if needed. The memo-style ROE is commonly used for completing brief examination reports and for requesting replacement ROE core financial pages and ROE interest rate risk pages whenever a new Thrift Financial Report (TFR) cycle becomes available during the course of an examination.

Year 2000 ROE

The Year 2000 (Y2K) ROE is a special purpose report used only for the Year 2000 examinations.

EDS Part II: Examination Completion Data

EDS Part II records the official completion date of the on-site examination work. Examiners enter data elements into the system on the final day of the on-site examination. For off-site examinations, examiners enter the data on the day office work ends. Upon data entry, EDS II is transmitted to Washington and the data is available in TIM reports.

EDS Part III: Supplemental Data

EDS Part III records examination findings as data that can be retrieved and analyzed. This data is entered into EDS Part III during or soon after an examination is completed. EDS Part III is designed to supplement the ROE. At the completion of the examination, EDS PART III is forwarded along with the ROE to the regional office for review and concurrence. Once in final form, EDS Part III is transferred to the OTS Washington data base with the report of examination. It is used by the OTS as a data source for analysis and planning and for inclusion in the next ROE.

EDS Part III is completed during the course of the examination and consists of two sections labeled on the data input screen as "R Exam Ratings" and "A Asset Quality and NPV Exposure Limits."

<u>Examination Ratings</u>

The Examination Rating Section records the CAMELS composite and component ratings for the examination. All ratings must be entered as N, 1, 2, 3, 4, or 5 to be accepted by the system. Entry of an "N" (the default rating for the system) indicates that no rating was assigned.

At the conclusion of the examination, it is the responsibility of the examiner in charge (EIC) to assign ratings. If the scope for a particular examination is not sufficient to assign a rating to each individual component, the EIC should only assign a rating to those components that were reviewed and assign an "N" to those components that were not reviewed. Federal regular and eligibility examinations report all ratings, while other examination types provide ratings only if any are appropriate for the individual examination. Regional Directors have the authority to accept a State examination as a substitute for an OTS examination on an alternating basis. State examinations are recorded in EDS as type 11 state interim examinations.

Refer to the Thrift Activities Regulatory Handbook Section 071, CAMELS Ratings, for a description of the criteria regarding the CAMELS composite and component ratings. Additional guidance to assist regulatory staff in assigning ratings is provided in the "Safety and Soundness Report of Examination Instructions" manual.

Asset Quality

The asset classifications in EDS may be compared with the asset classifications reported in the TFR as of the same date. (Beginning in June 1996, the asset classifications in EDS and the TFR use the same accounting standards. Prior to this date, EDS classifications were net of specific valuation allowances (SVA) while the TFR reported classifications gross of SVA. The current standard is to report both net of SVA.)

Examination Date

The date of the quarterly TFR information used in an examination is stored in the field identified on the input screen as: TFR financial data as of date. This date allows future comparisons between the thrift's current financial condition as reported in the TFR and the thrift's financial condition as of this examination. The date must be entered in the TFR date format. The date should not be more than 180 days prior to the start date of the examination and no later than the completion date of the examination.

NPV Exposure Limits

The interest rate risk net portfolio value exposure limits set by the thrift are stored here. This record allows a comparison of the limits with actual performance as reported in the Consolidated Maturity and Rate report (CMR).

EDS Part IV: Report of Examination and Close Date

EDS Part IV is more commonly called the Report of Examination (ROE) and is the document used to report examination findings. During the course of the examination, the examination team completes a draft version of the ROE on a personal computer using the Microsoft WORD ROE shell that is pre-formatted and downloaded from Washington before each examination.

EDS Part IV also includes the date the examination is closed and the report is mailed to the institution and transmitted to Washington. This date is referred to as the close, transmittal, or mail date and is not to be confused with the completion (of on-site work) date in EDS II.

At the completion of the on-site work, the ROE (along with EDS Part III) is forwarded to the regional office for review and concurrence. Events that occur subsequent to examination completion, but before the examination is closed, such as the institution's agreeing to corrective action, should be incorporated into the ROE.

The EDS Parts III and IV data are not transferred immediately to Washington by the examination team. Instead, they are transferred by direction of supervisory staff at the regional offices after they have reviewed the information. The review of EDS Parts III and IV can occur at the examination site (field review), the regional office (either after or during the examination), or both, depending on the examination type, examination scope, available personnel, and other criteria.

Once the report is in final form, a copy is sent to the institution and the ROE is transmitted to Washington EDS, thus closing the examination. (A copy of the final ROE is sent to the thrift, except field visit ROEs with no rating; these ROEs may be sent to the thrift at the region's discretion.) Additional copies may be sent to other agencies, such as the FDIC or the state regulator. A transmittal letter that merely acts as a cover memo accompanying the ROE is discouraged. EDS does not accommodate transmittal letters.

Entry into EDS of the date the ROE was transmitted to the institution indicates final acceptance by the regional office, after which the ROE document cannot be altered. The EDS data correction facility (DCF) may be used to correct errors. The paper copy of the ROE stored by the region is the official document of record.

At the time of transmittal, the examination must be current, based on all available information. A ROE with an outdated rating should never be sent to an institution. Any significant events occurring after the examination is closed should be addressed in a subsequent supplemental examination and in the Regulatory Plan.

A state ROE written in a format other than WORD may be converted to WORD or the text may be copied into a WORD document to be uploaded into EDS.

If a state ROE cannot be uploaded into EDS (e.g., the ROE is a WordPerfect document) a message such as the following should be entered into a memo-style ROE and uploaded into EDS:

> "This is an intervening state examination in accordance with provisions set forth in the Federal Deposit Insurance Corporation Improvement Act of 1991. The official hard copy Report of Examination (ROE) is retained with the examination workpapers. These files are stored at the OTS Regional Office. To obtain a copy of this ROE, contact the Regional Office."

A similar message may be used for IS/EDP ROEs written in WordPerfect if they cannot be either converted to WORD or copied into a WORD document.

REFERENCES

Office of Thrift Supervision

Thrift Safety and Soundness Report of Examination Instructions

Examination Data System, EDS User Guide

INTRODUCTION

This Handbook Section provides guidance to you as the examiner or other supervision staff assigned to work with enforcement actions or the Regulatory Action Data (RAD) system. RAD is the automated record of OTS enforcement activities initiated against institutions and individuals or other entities. It is the source of various internal and external reports on enforcement actions. You must record certain enforcement related information in the RAD system to allow the following actions to occur:

- Regional staff to actively and effectively manage caseloads and fulfill management reporting requirements.
- Washington staff to monitor selected cases and effectively perform oversight functions.
- The Enforcement division of the Office of Chief Counsel to prepare accurate enforcement activity reports, including monthly reports to the public.
- The Press Relations division of the Office of External Affairs to prepare accurate enforcement activity press releases.
- Applications staff to identify actions against individuals or companies with applications currently under review.
- Other OTS staff members to prepare or review reports on enforcement actions as needed.

The RAD System User Guidelines provides detailed instructions for use of the RAD system. Regulatory action data collected in the system includes significant informal enforcement actions and all formal enforcement actions.

Accuracy and Timeliness

Accurate and timely entry of enforcement action data in the RAD System is critical to the integrity of congressionally mandated monthly reporting of enforcement activity and to OTS monitoring and administration of such activity. Supervision and Enforcement staff must cooperate in reviewing monthly activity reports to ascertain that RAD data is up to date at each month end. The Thrift Information Monitoring System (TIM) provides a variety of reporting options to monitor and test RAD data.

Opening an Action

When OTS takes an enforcement action, you must enter the action into the RAD system and include the following information:

- Thrift or holding company docket number.
- An action code.
- Reason codes.
- *Initiated* date.
- Enforcement order number.
- Docket number of related entity, such as an affiliated thrift or holding company, if applicable.
- Designate whether the action is against a thrift or other entity.
- Comments identifying the target individual or entity and a description of the action.
- Enter the *effective* date of the action once the action takes effect.

Monitoring an Action

Examination and monitoring are a vital source of RAD data. During full scope examinations, you should review an Action History report (TIM EE AH) of all open actions for the docket. During the examination, you must check for compliance. You should note in RAD whether the target of the action is in compliance with the terms of the action, the date of your review, and any explanatory comments.

Closing an Action

As the activity associated with the action concludes, enter the close code, the close date, and concluding comments. You must enter all dates and supporting information within five working days of the actual event, and the information should be up to date by month end to facilitate accurate reporting. Some actions against individuals such as Part 513, Removal and/or Prohibition, Cease and Desist Order, Enforcement of Orders in U.S. District Court, or Injunctive Action, generally are not successfully closed before the death of the target of the action.

<u>Close Codes</u>

You may close actions with any of the following five close codes in the RAD system:

- AS – successful – when we find the deficiency or problem that it addresses resolved.
- AC – canceled – when we decide not to pursue it.
- AT – transferred – when a change in charter transfers responsibility for the action out of OTS jurisdiction.
- AM – merged – when the thrift disappears due to a merger.
- AD – opened-in-error.

Enforcement Action Codes

An enforcement action is OTS's response to violations of law, regulation, agreement, OTS-imposed conditions, or unsafe and unsound practices. The RAD System User Guidelines and Thrift Activities Regulatory Handbook Section 370, Enforcement Actions, provide more information on enforcement actions. Here is a list of codes for all enforcement action types within the RAD system.

F01	Formal Investigation
F02	Capital Directive
F03A	Suspension of Individuals Charged with Felonies
F03B	Immediate Suspension
F03C	Part 513 Action (suspension of practice before the OTS)
F03D	Notice of Prohibition
F04	Temporary Cease and Desist Order
F05	Removal and/or Prohibition Order
F06	Cease and Desist Order
F07	Civil Money Penalty
F08	Enforcement of Orders in U.S. Court
F09	Injunctive Action
F10	Restitution
F11	PCA Directive
S02	Supervisory Directive (includes §570.2 Determination, Notification, Request)
S03	Director's Resolution
S04	Mortgage Derivative Products and Mortgage Swaps Restrictions
S06	Growth Restriction
S07	Capital Plan
S08	Capital Plan Termination Notice or Modification Request
S10	Exempt Capital Directive
S11	Individual Minimum Capital Requirement Directive
S12A	Commitment Letter
S12B	Memorandum of Understanding
S15	Capital Maintenance Agreement
S17	Supervisory Agreement
S19	Request For Voluntary Management Changes
S20	Marketing Agreement
S21	Consent Merger Agreement
S23	Formal Enforcement Action Waiver
S99	Other Supervisory Action

Reason Codes

You must assign reason codes to identify the types of problems or deficiencies that the action addresses. Reason codes relate actions to examination types. RAD accepts multiple reasons for one action. The TIM system has a reporting option of listing actions limited to one select reason code, such as actions with a holding company reason code.

Reason Codes:

- Asset Quality
- Capital Adequacy
- Compliance
- Criminal Action Response Under 12 USC § 1829
- Discretionary
- Dismissal
- Earnings
- EDP (Information Systems)
- Historical
- Holding Company
- Increase Capital Above Minimum Capital Requirement (IMCR)
- Liquidity
- Management
- Other
- Presumed
- Sensitivity to Market Risk
- Trust
- Y2K

You can find a more detailed description of these codes in the RAD User Guidelines.

Actions Against Others (Not Thrifts)

OTS may initiate enforcement actions against an institution or an individual or other entity, such as a holding company or affiliate. You must code all actions against any entity that is not a thrift as against an other party and identify the party in the comments. This includes actions against persons, affiliates, holding companies, and subsidiaries. Always code actions against a thrift board of directors as actions against the thrift. Always code actions against individual directors as against others and enter a separate action for each individual. RAD automatically labels all Part 513, Removal or Prohibition, Suspension of Individuals Charged with Felonies, Immediate Suspensions, and Requests for Voluntary Management Change as actions against others.

For all actions against other parties, you must name the individual or entity in the comments. This allows you to use a word search to locate all actions against the specific individual or entity.

Actions against other entities can remain in effect for years after a thrift has disappeared (for example: investigations, restitutions, and civil money penalties). These actions remain the responsibility of supervision and enforcement staff as long as they are open. You may list inactive docket numbers in a TIM docket file for easy retrieval of RAD data on open actions filed under inactive docket numbers.

Actions Involving Holding Companies

Always code actions involving holding companies under the holding company's docket number, with the holding company reason code, and as against an other entity. Before 1998, RAD listed actions involving holding companies under a subsidiary thrift's docket number. Because holding companies change names and their relationships with thrifts, holding company actions coded under a thrift docket number (before 1998) identified the holding company by name and docket number in the comments. Therefore, you can locate all actions against a holding company by searching for the holding company docket number in a report of actions with the holding company reason code.

Amended or Initial Actions

RAD automatically designates new actions as “Initial.” When you modify an action, you must manually designate the action as “Amended” to provide for correct monthly public disclosure of modifications of orders and agreements.

Civil Money Penalties and Restitution

You must report all payments on civil money penalties and restitutions to the OTS Controller. The staff of the Controller’s office enters these transactions into RAD to maintain a correct record of outstanding balances. When the balance reaches zero, you should close the action with the "AS" code for Action Successful. If certain considerations require the action to remain in effect, you should enter the reason in the comments.

REFERENCES

Office of Thrift Supervision

Regulatory Action Data System User's Guide

Regulatory Bulletin Series

RB 18 series Enforcement Policy

United State Code (12 USC)

Federal Deposit Insurance Act

§ 1818(u)(1)(C) Public Disclosure of Final Orders and Agreements

INTRODUCTION

A Regulatory Profile is a concise written summary of the characteristics and condition of an OTS-regulated savings association. The Regulatory Profile includes the association's:

- Name, address, docket number, and other identifying information.
- Latest examination ratings and dates.
- Selected quarterly operating results.

Also, when necessary as explained below, the Regulatory Profile includes a brief narrative summary with four sections: Operating Profile, Identified Risks, Enforcement Actions, and Supervisory Strategy.

POLICY

The Regulatory Profile System designates all institutions as either low-profile or high-profile. Each designation has a different policy.

Low-Profile Institutions

Low-profile institutions generally meet all of the following criteria:

- Total assets less than $1 billion.
- Composite CAMELS rating of 1 or 2.
- No significant risk factors.

The OTS system automatically generates Regulatory Profiles for every low-profile institution using data from OTS national systems, including the Thrift Financial Report (TFR) and the Examination Data System (EDS). Profiles for low-profile institutions only include the following information:

- Name, address, docket number, and other identifying data.
- Latest examination ratings and dates.
- Selected quarterly operating results.

Regulatory Profiles for low-profile institutions are completely automated and do not require any input or maintenance by OTS employees.

High-Profile Institutions

High-profile institutions generally include thrifts that meet any one of the following criteria:

- Total assets greater than $1 billion.
- Composite CAMELS rating of 3, 4, or 5.
- Any institution designated by the supervising region as high-profile for any other reason, for example:
  - — Institutions with a Management component or Compliance rating of 3, 4, or 5.
  - — Institutions with a CRA rating of Needs to Improve or Substantial Noncompliance.
  - — Institutions with unique or highly specialized operating strategies (such as Internet-only, credit-card only).
  - — Institutions with significant high-risk activities (such as subprime lending).

Regulatory Profiles for high-profile institutions include the same system-generated identifying data, examination ratings, and operating results as low-profile institutions. However, Regulatory Profiles for high-profile institutions require periodic updates. The region maintains a brief narrative summary consisting of four sections:

1. <u>Operating Profile:</u> A brief description of the institution's financial condition and any unique operating strategies.

2. <u>Identified Risks:</u> A summary of any significant risks identified at the institution, including safety and soundness, compliance, or other risks. This section should clearly identify any material problems or concerns.

3. <u>Enforcement Actions:</u> A summary of all active, outstanding enforcement actions, including a brief description of the violation or problem, the resulting enforcement action, and the date of the action.

4. <u>Supervisory Strategy:</u> The supervisory strategy for addressing each of the noted problems or concerns. This section may list monitoring procedures, corrective actions, and specific items for on-site examination.

The region creates this four-section narrative summary whenever an institution meets any of the high-profile criteria listed above. Regional employees update the summary at least quarterly for all high-profile institutions. If an institution is high profile but there is no information to report in a particular section, regional employees should note this explicitly within the relevant section. For example, “No outstanding enforcement actions.”

The Regulatory Profile System update screen also includes a “Final Version” checkbox to indicate that narrative input is no longer in draft form but represents a final version of the text.

The policy governing Regulatory Profiles is somewhat flexible. The only systemwide requirement is that the regions create a brief narrative summary, and update it at least quarterly, for every high-profile institution they supervise.

REFERENCE

For detailed policies and procedures, see the Regulatory Profile System Users Guide on the OTS Intranet. This Guide is accessible to all employees by clicking on the Help option.

This Handbook Section provides guidance to you as the examiner. We refer to “you” in a general sense. Regional directors may assign responsibilities to certain other positions as appropriate.

This section provides guidance in five areas:

- Examination strategy (includes scheduling).
- Scoping examinations.
- Managing examinations.
- Off-site examination procedures.
- Joint examinations.

EXAMINATION STRATEGY

Concentration on improving examination efficiency and a risk-focused regulatory approach are critical strategies to ensuring a sound thrift industry. These strategies will help you assess the overall safety and soundness of an institution in a timely manner and ensure the accuracy of its composite and component ratings. As a regional office, you are responsible for developing appropriate management tools and performance standards to affirm that our examination strategy is consistently met. An important aspect of this strategy is the scheduling of examinations.

Scheduling Examinations

You must schedule full-scope (type 10), on-site examinations of insured depository institutions once during a 12-month cycle or once during an 18-month cycle. Supplemental examinations are necessary under certain conditions.

The Office of Thrift Supervision (OTS) measures the 12-month and 18-month cycles from the “close date” of the last examination to the “start date” of the next examination. The “close date” is the date the Report of Examination (ROE) is transmitted to the institution.

Regional offices may accept full-scope, on-site examinations conducted by the regulatory authorities of state depository institutions on an alternating basis instead of an OTS examination, if such examinations meet the requirements and objectives of OTS’s examination strategy.

12-month cycle

You must conduct a full-scope (type 10), on-site examination of the institution once during each 12-month period unless the institution meets the 18-month cycle requirements below.

By conducting examinations annually you increase your chances of discovering problems and resolving them early. Regional offices may conduct full-scope, on-site examinations more often than prescribed by statute.

All de novo institutions are subject to the 12-month examination cycle. The 12-month examination cycle should continue until management has demonstrated its ability to operate an institution in a safe and sound manner.

18-month cycle

An 18-month examination interval applies to insured institutions of $250 million or less that meet all of the criteria of a “well-run” institution (12 CFR § 563.171):

- The most recent examination received a composite CAMELS rating of 1 or 2.
- The most recent examination received a Management component rating of 1 or 2.
- The institution is well-capitalized as defined under Section 38 of the Federal Deposit Insurance Act (FDIA) and 12 CFR §565.4.
- The institution is not currently subject to a formal enforcement proceeding or order by the OTS or the FDIC.
- The institution has not been acquired (change in control) during the 12-month period since completion of the last full-scope examination.

Vary from the 18-month examination schedule in the event of an enforcement action, an acquisition or change in control; or a change in asset size, PCA rating, CAMELS rating, or management component rating. If a triggering event occurs in any of the following timeframes at an institution that otherwise meets all of the criteria for an 18-month examination interval, you must conduct a full-scope examination within the appropriate interval:

- Within 9 months of the "close" date of the prior full-scope examination, start the next examination no later than 12 months from the close of the last full-scope examination.
- Between 9 and 12 months since the close of the last full-scope examination, start the next examination within 90 days.
- Twelve or more months since the close of the last full-scope examination, start the next examination within 90 days, but no later than 18 months from the close of the last full-scope examination.

Conversely, if an institution under a 12-month examination interval later becomes eligible for an expanded interval, the interval can be expanded to 18 months immediately.

Supplemental Examinations

More frequent or supplemental examinations may be necessary for the following institutions:

- De novo or newly insured institutions.
- Institutions that have had a change in management, control, or operations.
- Institutions under an enforcement agreement.
- Institutions whose conditions undergo a significant change.

Use special limited examinations (type 40) for supplemental reviews focusing on high-risk areas. Special limited examinations or other abbreviated examination programs do not satisfy the 12/18 month requirement.

To determine if an institution needs a supplemental on-site examination, focus on the following factors:

- Changes in key financial ratios and indicators.
- Changes in business activity and strategy, such as a change in loan product lines, the investment portfolio, or the deposit structure.
- Deterioration in asset quality indicators such as non-performing assets.
- Compliance with prior enforcement actions.
- Negative earnings, unfavorable earnings trends, or dependence on nonoperating income.
- The levels and composition of capital, as well as trends in capital formation and accumulation.
- An excessive rate of growth or a level of growth that exceeds capital levels or regulatory or supervisory directives.
- Other information such as the independent audit report, news articles, supervisory correspondence, and information obtained from examinations of other institutions.

SCOPING YOUR EXAMINATION

Scoping an examination means you determine the specific examination procedures to use and the depth of review. Scoping may occur on site or off site before the examination, when it begins, or both.

To help OTS meet its strategy of an on-site presence in each institution every 12 or 18 months, place a special emphasis on risk analysis and prioritization. That is, vary the depth of review in each area according to an institution's size, activities, and condition. Do less review in those areas where no significant present or potential risks exist and more review where major risks are present or possible.

Consider all handbook programs and questionnaires when setting the initial depth of examination review. Use only programs and questionnaires appropriate to the scope and examination. In some circumstances, you will not need all or even a majority of the programs. (See "Selecting Examination Programs and Procedures" discussed later in this section and Thrift Activities Handbook Section 011, Program Use.)

Preliminary Scoping of Examinations

The preliminary scope may provide information needed to determine staff expertise requirements, the examination start date and duration, and strategies for conducting the examination.

Preliminary scoping may be done off site or on site. Items that may be reviewed off site include the following:

- The Regulatory Plan (see Thrift Activities Regulatory Handbook Section 050) for the institution.
- Prior thrift, holding company, and service corporation examination reports, work papers, and recommendations.
- Preliminary Examination Response Kit (PERK) documents completed by institution management prior to the start of the examination.
- Documentation on supervisory and enforcement actions.
- Results of off-site monitoring.
- Correspondence and internal memoranda involving the institution.
- Economic information about the institution's market area(s).
- News articles.

Ensure that the scope does two things:

- Provides for a sufficient review of high-risk areas.
- Includes clear, specific guidelines on the depth of review needed in each area.

Major areas of risk do not necessarily mean problems; some risk is part of conducting any profitable institution. Include procedures that enable you to determine if the institution's level and management of risk is unsafe and unsound. Also concentrate on changes in operations or management because these can pose a significant risk.

Ongoing Scoping of Examinations

Whatever the size or condition of the institution, you will be more productive by using a well-defined scope. Avoid beginning with a broad scope and then trying to narrow it during the examination. Instead, focus first on areas of major risk and then expand the scope as you uncover or suspect significant problems or changes. Also expand the scope if you can assign ratings only by doing more procedures. Determining the depth of review (Level II and Level III procedures) within specific programs may require a preliminary analysis (Level I procedures). For more information about the three levels of review, see Section 011 of this Handbook, Program Use.

The ongoing determination of scope, particularly the depth of review within each program, requires the involvement of each member of the examination team:

- <u>The Examiner in Charge (EIC)</u>: Ensure that the team is aware of the procedures needed to efficiently meet the scope. Discuss possible changes to the scope with your team throughout the examination.

Discuss any significant changes in the scope, projected staffing needs, or completion date with your managing supervisor as soon as you anticipate these changes. These discussions are important because any changes will affect how your regional office plans its regulatory activities.

- The regional director or designee: Approve expansions of scope that will cause the examination to extend beyond the original time frame.

- Safety and soundness examiners: Communicate any significant changes to the scope and the reasons for them with examiners involved in holding company, consumer compliance, trust, and information systems (IS) examinations. Share significant findings and conclusions to avoid duplicating efforts.

- Regulators when FDIC is involved: Maintain close communication with FDIC regulatory authorities and appropriate state regulatory authorities.

When you start an on-site examination, review additional information that may affect the scope as soon as possible. Examples of scoping materials commonly reviewed on site include the following:

- PERK documents available at examination commencement.
- Minutes from the meetings of the board of directors, board committees, and management committees.
- Board reports and management reports.
- Internal audit reports.
- Internal Asset Review (IAR) reports.
- General ledger and subsidiary ledgers.
- Business plan.
- Operating budget.
- Any new contracts (e.g., employment, information systems).
- Leases.
- Loan registers.

Additional Scoping Considerations

As soon as practical, before or at the beginning of the examination, the EIC must meet with the CEO to discuss items of interest or concern that could affect the scope. At this meeting, you should clarify administrative details.

It is helpful to prepare for the meeting with the CEO in advance so that you cover all items of interest efficiently. Topics that could affect the scope of this discussion include the following:

- Changes in control.
- Changes in management.
- Actions taken to correct deficiencies mentioned in prior examination reports and audit reports.
- Operating performance in comparison with the budget.
- Significant changes in operations or strategies.
- Any significant concerns expressed by management.
- Economic and competitive conditions in the market area.

The EIC might also discuss with the CEO, or with a designated institution representative, the following administrative details:

- Time limits for receiving requested information.
- The availability of the examiners to answer questions from the staff preparing requested information.

- Names of key contact people, facilities and parking availability, hours for work, use of equipment, etc.
- The expected duration of the examination, any planned interruptions (these should be kept to a minimum), and names of assisting examiners.
- A meeting with the independent auditor and review of independent audit work papers, in accordance with regional policy, if applicable.
- Regular meetings with the CEO to discuss the progress of the examination and to address any other issues of concern to the CEO or the EIC.
- An examination exit meeting with the institution's senior management to discuss examination findings, the examiner's overall conclusions, and recommendations (see Thrift Activities Regulatory Handbook Section 070, Overall Conclusions).

Preliminary Examination Response Kit

Several documents comprise the Preliminary Examination Response Kit (PERK). The regulator selects certain documents and sends them to the institution for completion by institution management prior to the examination. The preparation and availability of this information before the beginning of the examination, assists OTS and the institution by determining examination scope and increasing the efficiency of the on-site examination.

General Instructions

Prepare the PERK by selecting various documents and information requests specific to the institution from the list on the Summary Schedule (PERK 001). You may access the PERK electronically from your regional office M: drive. This enables you to revise and print the individual documents needed for the examination of a particular institution.

You should tailor the summary schedule to the institution and type of examination. Request the minimum information needed to conduct a risk-focused examination based on the examination scope. This approach will increase the efficiency of the on-site examination and reduce the burden on savings associations, particularly for highly rated, well-managed institutions engaging in traditional activities.

List items needed for both phases of a concurrent examination, for example, concurrent safety and soundness and compliance examinations, as an information request in only one schedule – either the safety and soundness examination summary schedule or the compliance examination summary schedule.

To meet the OTS customer service plan standards, send the PERK to an institution four weeks prior to the examination start date. Contact the institution and inform management of any delays so that they can plan for a shorter turnaround. If you are performing off-site examination procedures, consider advancing the request date beyond the four weeks prior to the examination start date.

<u>The EIC or designee</u>: At the beginning of the examination, request the completed PERK from institution management. Be aware of information that management may have sent to the regional office prior to examination commencement.

Encourage institution management to submit the requested information on internally generated reports, such as computer printouts or software spreadsheets if these reports will facilitate the completion of the examination.

At the conclusion of the examination, complete a summary schedule for the PERK at the next examination. Update it when necessary to facilitate the scoping and planning process for the next examination.

<u>The examiner</u>: Review management's responses and discuss them in greater detail with management including any unclear answers or areas that may affect the scope of the examination. Ensure that the appropriate dates are entered on the first

page of each document and that the "Institution Name" and "Docket Number" are indicated on each document and any attachments.

PERK Letter (PERK 000) – Prepare the PERK Letter on OTS regional/area office letterhead in the same general format exhibited in the sample letter. You may modify the PERK letter for use with safety and soundness, compliance, information systems, trust, special limited examinations, or concurrent examinations of any combination. Insert the appropriate paragraph as provided in the examples or create a paragraph accordingly. You may identify in the letter items needed for both phases of a concurrent examination, such as concurrent safety and soundness and compliance examinations. The institution need only provide one copy.

The PERK letter must include all of the following information:

- A start date for the on-site examination.
- The examination as of date.
- The number of on-site staff and an estimation of the amount of time required to conduct the examination.
- A contact person's name and phone number, usually the OTS official who signs the PERK letter and expects to field questions from the institution, e.g., the EIC.

Summary Schedule (PERK 001) – The summary schedule lists (1) the PERK documents enclosed in the package to the institution and (2) suggested CAMELS-related requests that should be tailored to the scope of the examination. You may add additional requests and delete unnecessary or irrelevant requests. You should make a determination as to the items necessary to complete an on-site examination of the institution, and provide dates and dollar limits where appropriate. Each request should be indicated by an "A" (completion required 10 days in advance of the examination), "X" (provide at examination commencement), or "R" (make available for on-site review). In a concurrent examination, the safety and soundness and compliance EICs should coordinate to ensure that items needed for both examinations are listed in either the safety and soundness summary schedule or the compliance examination summary schedule.

Institution management should complete summary schedule requests and provide the information to the EIC prior to or at the commencement of the examination as indicated ("A," "X," or "R"). The examiners may also use the summary schedule as a checklist to keep track of the documents as institution management provides them.

"Core" PERK

Include the following documents in the PERK that is sent to the institution.

Management Questionnaire (PERK 002) – Prior to sending the PERK to the institution, enter the previous examination date and the examination commencement date at the top of the questionnaire.

You should carefully review written explanations for completeness and accuracy, and initiate further discussion with the managing officer, if necessary. If the response to No. 14.a. or 14.b. indicates a reportable event or violation of the applicable regulation, you must notify the FDIC regional office.

Schedule of Directors, Senior Executive Officers, and Attorneys (PERK 003) – The institution may complete the compensation schedule in the format exhibited in the PERK or any format currently in use by the institution that contains substantially equivalent information. Directors, senior executive officers, and designated attorneys are to be listed on the compensation schedule. "Senior executive officers" are those responsible for the management function of the institution. See RB 27a and 12 CFR § 563.555 for pertinent definitions.

Internal Control Procedural Questionnaire (PERK 004) – Each section of the questionnaire should be completed by institution personnel familiar with that section; for instance, the Vice-President of Lending might complete the Lending section. The EIC, or designee, should review the entire questionnaire and sign in the spaces provided. Note that the appropriate response may not always be in the affirmative, in which case the institution should provide an adequate written explanation.

Information Systems (IS) Questionnaire for Insured Institutions (PERK 005) – The IS Questionnaire should be sent out on every annual safety and soundness examination and completed by institution personnel. The institution should forward a copy of the completed questionnaire to the IS examination manager at the regional office. You should review the questionnaire and investigate inappropriate responses. Note that the appropriate response may not always be in the affirmative.

Electronic Loan Data (ELD) Request – The ELD Request is a new method for reviewing and analyzing loan portfolios. It is a voluntary submission by institution management of certain loan information in an electronic format, such as a personal computer diskette. If you request this schedule, you must ensure that duplicative information requested in the summary schedule is deleted from the request. The ELD Request will formally be included in the PERK when it is approved.

Compliance Examinations

Include the following documents in the PERK when a compliance examination and a safety and soundness examination are conducted concurrently. The regional office may (1) determine that a compliance examination will be conducted separately from the safety and soundness examination or (2) consider requests by the institution to conduct non-concurrent examinations.

Compliance Examination Summary Schedule (PERK 006) – The Compliance Examination Summary Schedule is a list of standard requests that should be tailored to the scope of the examination, i.e., you may add additional requests and delete unnecessary requests. Coordinate with the safety and soundness EIC to ensure that items needed for both the safety and soundness and the compliance examinations are listed on either PERK 001 or PERK 007. Information requested on the Compliance Examination Summary Schedule should be provided to the EIC prior to or at the commencement of the examination.

Fair Lending Questionnaire (PERK 007) – The managing officer should provide answers to the questionnaire and attach additional pages if space provided is inadequate.

Community Reinvestment Act Information (PERK 008) – Responses to requests for CRA information should be as specific as possible and signed by both the institution’s managing officer and CRA officer. If the institution is not involved in a particular activity, management should explain why they chose not to participate in a program addressing the specific assessment factor.

CRA Optional Information - Small Institutions (PERK 015) – This outline guides an institution by identifying the types of supplementary information that may provide examiners with a better understanding of the institution’s performance. Response to this request is voluntary.

CRA Public File Summary (PERK 016) – This document summarizes the information from the CRA Public File that the OTS uses to evaluate CRA performance in both small and large institutions.

Supplemental Schedules

You may include in the PERK the applicable documents listed below if the particular area is to be examined in conjunction with the safety and soundness examination.

Schedule for Retail Nondeposit Investment Products (PERK 009) – Request completion of this schedule by any savings association engaged in the retail sale of nondeposit investment products such as stocks, bonds, mutual funds, or annuities.

Subordinate Organization Questionnaire (PERK 010) – The institution should complete this questionnaire for each subordinate organization that significantly affects, or has the potential to significantly affect the institution's operations, unless noted otherwise. Subsidiaries that have an insignificant effect on the institution should be listed separately with an explanation as to why they are considered insignificant. The Subordinate Organization Questionnaire should be completed by those who have direct knowledge or can obtain it by appropriate inquiry. If the institution has no investment in subordinate organizations, it should so state in answer to No. 1. Separate questionnaires should be used for each subordinate organization, including second tier corporations and other sublevels.

Information Systems (IS) Information Request Schedule for In-House Institutions and Service Bureaus (PERK 011) – This schedule should be used for examinations of independent service bureaus and institutions with an in-house data center. The schedule of information requests should be provided to the EIC prior to or at the commencement of the IS examination.

Trust Examination Summary Schedule (PERK 012) – The Trust Examination Summary Schedule of information should be made available to the EIC prior to or at the commencement of the trust examination. Management should provide a brief explanation, or the name of an individual to contact, for any information they do not provide.

Mortgage Banking Questionnaire (PERK 013) – Completion of this questionnaire should be included in the PERK if the institution or any subsidiaries are engaged in mortgage banking during the examination period.

Schedule of Stockholders (PERK 014) – This schedule should be completed to determine the stock activity that has taken place between examinations.

Selecting Examination Programs and Procedures

You should consider all programs and questionnaires within the scope of the examination. Use programs and questionnaires deemed appropriate, but only to the extent necessary to address the scope and support the examination conclusions. In some circumstances, not all or not even a majority of the procedures will be needed.

For example, if your review of the policies, structure, administration, and results of the institution's internal asset review program reveals that the program is sufficient and the results are accurate, you may place a greater reliance on the institution's internal review. The risk that the institution is not adequately reviewing and classifying its assets would be low, so more detailed examination procedures would generally not be necessary.

When using this risk-focused examination approach, use sound professional judgment to ensure that the depth of review is sufficient to accurately assess the institution's condition, but is not excessive. For further information regarding the examination program and the three levels of review, refer to Section 011 of this Handbook, Program Use.

Work Paper Documentation

Examination work papers should include a title or well-marked description of the work paper purpose, the scope for the particular area of review, the sampling criteria used, the procedures performed, and the preparer's initials. Documented procedures support the analysis and help maintain the integrity of the work paper.

You are required to support all the applicable elements reviewed under each CAMELS component either in the work papers or in a conclusion documented on the appropriate program. In addition, the conclusion for each work paper or area of review should summarize the examination findings, support the composite rating (in addition to the component rating), and indicate if any corrective or enforcement action is necessary.

However, you should avoid excessive documentation and include only information that is relevant or may require follow-up. Time spent recording extraneous information would be better spent examining high-risk areas. To facilitate any follow-up review that may be necessary, you should also document the name and title of persons or a description of the records from which information was obtained. Schedules prepared by the institution should be clearly marked as such. The EIC or designee is required to review and initial all work papers, indicating agreement with the conclusions reached and ensuring that assistants have complied with the applicable documentation requirements. The TFR, UTPR, and other multi-page printed documents need only be initialed and dated on the first page. The EIC should ensure that all comments, charts, and appendices have been carefully checked by exam staff. At a minimum, the EIC's supervisor will review the work papers prepared by the EIC and the supporting documentation for the report comments.

Continuing Examination File and the General File

Continuing Examination File

Include the following items, only if applicable to the particular institution being examined, in the Continuing Examination File (CEF), or file them with the applicable examination programs and carry them forward from examination to examination until no longer applicable. Maintenance of these documents preserves examination continuity and reduces excessive requests for information during examinations.

- Management and Director Committees and Members (PERK)
- Organizational Chart (PERK)
- Officer Resumes (PERK)
- Directors' and Officers' Home Addresses (PERK)
- Enforcement Documents
- Schedule of Branch Offices and LPOs
- Copy of Charter and Bylaws
- Copy of Conditions for Insurance (in force)
- Summary of Leases
- Holding Company/Affiliates Corporate Structure (PERK)
- Internal Audit Program (PERK)
- Stockholders' Schedule (PERK)
- Proxy Statement
- Approved Appraisers and Qualifications (PERK)
- Employment Contracts (PERK)

If an institution policy must be included as part of work paper support, file it in the appropriate CAMELS section of the work papers. Similarly, include the business plan and budget requirements in the Management/Administration work paper file.

General File

The general file contains the administrative information related to the examination, and is organized to correspond with the administrative section of the Handbook.
Include the following items in the general file:

- Exception Sheets
- Examination Strategy, Scoping, and Management Program
- PERK Summary Schedule (for next exam)
- Regulatory Plan
- Pre-Assignment Analysis
- Overall Conclusions Program
- EDS Part III Interim Report
- Recent Correspondence
- Newspaper Clippings

You should use exception sheets to record all specific regulatory and policy violations that are not specifically discussed in the ROE. Either the managing officer or the appropriate department head must provide a disposition for each problem noted and initial the exception sheet. Provide a copy of all exception sheets to the managing officer.

EXAMINATION MANAGEMENT

Managing examinations is as important as scoping them. Effective management of the examination expedites and enhances the examination process by ensuring that objectives are met efficiently. The level and sophistication of management methods and procedures will vary depending on the activities to be performed and the size and nature of the institution.

EIC Responsibilities

The EIC carries the primary responsibility for managing the examination. Key elements the EIC should consider:

- The examination objectives: The EIC must ensure that the assistants understand the objectives of the examination and for their assigned programs. Objectives should be specific as to results desired.

  — The examination procedures contained in the individual programs are designed to be comprehensive. So, select only the appropriate procedures within each program. Assistants should notify the EIC as questions occur regarding scope or depth of review.

- Organization: This involves scheduling meetings with institution personnel; arranging appropriate workspace for regulators; prioritizing and scheduling work flow; communicating examination status; preparing the examination report; and preparing, filing, indexing, and reviewing work papers.

- Assignments and job monitoring: The EIC must determine the expertise necessary to perform certain aspects of the examination and make assignments accordingly. When warranted, assign major areas to individual assistants. Depending on the size of the job, delegate certain management responsibilities to assistants for efficiency and to improve upon administrative and management skills of assistants. Also consider training and development needs when making examination assignments.

  — Whenever possible, assign assistants to program areas that they can complete, including report pages and comments, before leaving the assignment. This allows for efficiency and accountability and provides necessary on-the-job training.

  — Monitor assistants' performance throughout the examination to ensure that objectives are being met according to schedule and to prevent minor problems from growing. Early identification of work-related problems also allows the assistants the opportunity to correct mistakes and to immediately improve upon skills.

- Budgeting and monitoring overall time: Consider the time budget when assigning tasks. A useful tool for improved personnel planning is a time and planning summary that is organized according to the sections contained in this Handbook. It specifies the areas for which procedures are planned and provides for a comparison of actual and budgeted hours. Add, as needed, any activities not included on the time sheet.

  — Assign priorities to the critical categories and determine optimal timing of simultaneous activities. Ordinarily this can be accomplished by assigning categories of related programs to one assistant who subsequently may supervise others. If time allows, it is also most efficient to have one assistant complete interrelated programs to avoid duplication of effort.

  — To minimize costs and disruption for the institution, it is important that the examination be conducted as quickly as practical. A stable crew with minimal interruptions of staff time allows for continuity and efficiency. It is the EIC's responsibility to discuss any planning problems with a supervisor. If institution management is concerned about scheduling, include this matter in your discussion.

  — Monitoring the progress of the examination allows for early adjustments to the scope, staffing, and completion date, as necessary, for the examination. The EIC is responsible for notifying a supervisor as soon as adjustments to scope are a consideration.

- On-the-job training and evaluation of assistants: Assistants may need guidance, depending on their experience and ability. The EIC should encourage questions and ensure that someone is available to provide guidance. Depending on the size of the job, the EIC should be familiar with the work performed by the assistant(s) so that you can make fair and constructive evaluations of the work performed.

- Ensuring that PERK information is received and distributed: The PERK is sent to the institution prior to the beginning of the examination. The EIC should set up controls to ensure that all information requested is received as early as possible. The EIC should also list any other items needed and submit the list to the contact person as early as possible to allow time for preparation by institution personnel. Encourage institution personnel to ask questions if instructions for preparation of requested information are unclear.

- Serving as the primary communications link: The EIC is the focal point for communications on significant matters. Assistants, institution personnel, and regional office staff must all know how to communicate information and when to share information. During examinations it is important that answers to significant items be given by only one responsible individual. The EIC should coordinate this in case questions arise.

- Ensuring a cooperative and positive working environment: Conduct examinations with as little disruption, conflict, and confusion as possible. A positive work environment fosters the productivity of the team members. Disagreements will occur at times, but avoid an antagonistic role. Allow for regular meetings with management to discuss findings and questions, and avoid monopolizing the time of the staff as much as possible. A professional and considerate approach usually results in cooperation from the institution staff.

- Determining that the examination meets the overall examination objectives: At the conclusion of the examination, the EIC should ensure that the examination meets the objectives and that examiners followed appropriate procedures for all examination functions.

Off-Site Examination Procedures

On-site examinations are essential to OTS's mission; however, some examination procedures may be conducted off site as proficiently as they can be conducted on site. Given the overall health of the industry and the experience level of the examination staff, the OTS may be able to fulfill its examination responsibilities at many institutions and limit on-site examination time.

Performing examination procedures off site is optional. Regional directors or their designee should determine whether off-site examinations are feasible and develop appropriate policies and procedures.

An off-site examination does not replace an on-site examination. In simple terms, more procedures may be performed off site at the beginning and end of an examination. Some of the advantages of performing procedures off site may include reduction in travel expenses and a reduction in the disruption to normal thrift operations attendant with even the best-run examinations.

Institution Selection Criteria and Examination Procedures

You should determine whether off-site examination procedures may be used in an institution based on certain criteria, including the institution's CAMELS rating, prior history, complexity of operations, reliability of data, and other factors. Typically, small, highly rated institutions would be the most likely candidates for these procedures. You should be able to demonstrate that a tangible benefit can be gained from using off-site examination procedures.

The exact combination of on-site and off-site work is a function of relevant factors unique to the institution and the examination crew. Flexibility is retained through the absence of any firm guidelines such as asset size, rating, or location where an off-site examination may or may not be conducted. Open lines of communication with institution personnel are essential at all examinations, but extra steps may have to be taken to keep those lines open during off-site portions of the examination. Advise thrift management of the start and completion of off-site work. Finally, exercise judgment so that work that is best performed on site is performed on site.

PERK

You may revise the PERK letter to alert institution management that some of the examination work will be conducted off site.

As discussed in greater detail in this section, you may request PERK information from institution management in several ways:

- Complete the information prior to the start of the examination.
- Provide the information at examination commencement.
- Make the information available for on-site review.

Unless it is practical to retrieve items from the institution, at least some items should be requested in advance for delivery to the field office or other appropriate location. If you select this option, the PERK should go out a few days earlier than recommended in the normal customer service standards.

Do not require thrifts to photocopy and ship materials to examiners if it creates rather than reduces regulatory burden. Regulatory staff will have to gauge the resources and attitudes of each thrift examined using off-site examination procedures. Again, keep open the lines of communication with management.

Examination Data System I & II

Examination Data System (EDS) I and II should continue to reflect the actual start and completion dates of examination work performed on site. The dates used for EDS I and II should correspond with the dates disclosed in the cover page of the examination report.

Scoping

Scoping may be done off site and on site. See the discussion presented earlier in this Section on Examination Scoping.

Examination "Entrance" Meeting

At the initiation of the examination, hold a meeting with management. Discuss examination objectives, examiner assignments, and any other relative administrative issues. This meeting can be held by telephone, or in person if distance permits. In addition to an entrance meeting, the EIC should conduct weekly meetings (by telephone if off site) with the appropriate institution personnel to discuss current findings, as required by the OTS Customer Service Plan.

Suggested Off-Site Examination Procedures

Other than asset review and TFR verification, many of the examination procedures could potentially be completed off site, as long as the appropriate information is obtained. The following is a partial list of examination procedures that could be considered for off-site completion. Again, flexibility is the operative word. If the procedures listed below or any other procedures can be efficiently performed in whole or in part off site, consider doing them off site during the time frame assigned to an off-site office.

<u>Capital</u>

- Review SEC filings and pertinent correspondence.
- Evaluate adequacy of and trends in capital.
- Evaluate management reports and the business plan to determine adequacy of capital

planning, earnings retention, and dividend policy.
- Outline and draft comment.

Asset Quality

- Review applicable policies, as deemed necessary (loan, investment, appraisal, etc.).
- Identify asset review samples.
- Review internal loan review procedures and resulting reports.
- Review asset quality trends to determine any potential areas of concern. Stratify loan data in pivot tables to identify concentrations, sources of delinquencies (loan type, loan age, loan office), etc.
- Evaluate the adequacy of loss allowances.
- Review regulatory limitations.

Management

- Review business/strategic plan.
- Review employment contracts.
- Review completed management questionnaire.
- Review internal/external audit reports.
- Review electronic data processing agreements.

Earnings

- Review financial reports.
- Identify earnings components, identify trends, and assess results.
- Review budget and the planning/monitoring processes.
- Outline or draft comment.

Liquidity

- Review applicable policies and procedures.
- Outline or draft comment.

Sensitivity to Market Risk

- Review applicable policies and procedures.
- Review IRR modeling and assess the institution's exposure position.
- Determine overall funds management strategies.

Administrative

- Construct work paper files.
- Prepare/finish ROE.

Examination Conclusion

At the conclusion of the examination, review the examination report and update the regulatory plan. Also ensure that the institution takes prompt corrective action for any problems found during the examination and closely monitor the institution's condition for any recurrence of these or new problems.

OTS regional staff must send the report of examination to 1- and 2-rated institutions within 30 days and to 3-, 4-, and 5-rated institutions within 45 days from completion of on-site examination activities.

Refer to Thrift Activities Regulatory Handbook Section 070, Overall Conclusions, and Section 320, Meetings with the Board of Directors, for other appropriate examination closing procedures.

OTS/FDIC Joint Examinations Process

The OTS and FDIC regional staffs should meet regularly to review the examination schedule. The FDIC should indicate those examinations in which they desire joint participation. All FDIC savings association examination activities will be performed on a joint basis unless compelling reasons dictate otherwise.

For joint examinations, the FDIC and OTS should jointly scope the examination at the EIC level or at the respective regional office level. Disagreements over scope should default to the broader alternative. When examinations of savings association affiliates are considered necessary, the EIC should decide how to conduct the examinations.

For non-joint examinations, the OTS should determine the scope and provide the FDIC a copy of the proposed final report and allow a ten-day period for review and comment prior to the OTS transmission to the institution.

OTS is responsible for specialty examinations.

Nothing in the joint OTS/FDIC agreement should alter the normal examination and supervisory cooperation with state authorities.

Report of Examination

Joint examinations will represent a division of responsibilities among the joint staff; the OTS and FDIC should each provide an EIC, who will share responsibility for managing the examination and will be responsible for resolving interagency differences during the examination process. EICs of both agencies should coordinate and communicate during the examination to assure examination objectives are achieved with a minimum of redundancy.

The FDIC's ROE will be for internal purposes only, although they will provide a copy to the OTS. If the FDIC Board authorizes an enforcement action, however, the FDIC would then transmit its examination report to the institution. As the OTS and FDIC regional staffs prepare the concurrent reports, they should attempt to resolve all significant differences of opinion concerning the thrift's overall condition and the enforcement or corrective action needed.

The OTS view will prevail concerning non-substantive differences in examination interpretations, conclusions, and report comments. Substantive differences in examination conclusions that could lead to an enforcement action by the FDIC if not pursued by OTS, and that the EIC cannot resolve, should be referred to the OTS and FDIC regional offices for resolution at the time such differences are identified. The regional offices must resolve such differences within ten working days. If they cannot resolve such differences following full review and communication between the regional offices within ten working days, the regional offices refer the matter to the FDIC Director of Supervision and OTS Deputy Director. It is expected that they will resolve such differences within ten working days. If the differences remain unresolved, the FDIC should so notify OTS of the differences and that they will seek corrective action authorization from the FDIC Board.

Prepare the OTS examination report using GAAP as the appropriate accounting treatment for financial accounting information. Use OTS regulations, policies, and directives in reaching examination conclusions.

The OTS and FDIC should routinely copy one another on institution-related correspondence. The OTS provides the FDIC with copies of examination-related correspondence.

Examination work papers, loan line sheets, report pages, and findings should be shared, but retained by the OTS following completion of the examination, with interim examination access provided to the FDIC upon request.

Board of Directors Meeting

The OTS and FDIC should jointly participate in examination-related meetings with management and directors during and at the conclusion of joint examinations.

The FDIC should communicate all actions taken by the FDIC Board to the institution after notification to the OTS.

Enforcement Actions

The OTS regional director should endeavor to advise the FDIC regional director of, and solicit written input on, all proposed OTS enforcement actions. The FDIC will have ten working days to respond. The OTS regional director should provide the FDIC regional director with a copy of the final enforcement document within five working days of execution. The OTS regional director should also provide a written explanation of the reasons why OTS did not take any of the FDIC-recommended actions.

Likewise, the FDIC regional director should endeavor to advise the OTS regional director of, and solicit written input on, all proposed FDIC enforcement actions. The OTS will have ten working days to respond. The FDIC regional director should provide the OTS regional director with a copy of the final recommendation to Washington. The FDIC regional director should also provide a written explanation of the reasons why the FDIC did not take any of the OTS-recommended actions.

Regional staff should resolve significant differences concerning corrective and enforcement actions. If regional staff cannot resolve a significant issue, they should submit the issue to the FDIC Director of Supervision and the OTS Deputy Director. It is expected that they will resolve such differences within fifteen working days. If the differences are irresolvable, the FDIC can recommend backup action to the FDIC Board. The FDIC should not direct corrective action until the FDIC Board authorizes such action.

Divestiture Plans/Brokered Deposit Waivers

The FDIC regional director should advise the OTS regional director of its intent to approve or deny, or otherwise exercise its independent authority with respect to a divestiture plan or brokered deposit waiver, prior to communication with the thrift institution.

The FDIC should coordinate its efforts with the OTS to ensure that such actions are consistent with OTS-approved capital plans, as long as conditions at the savings association have not changed to any material extent (in the opinion of FDIC).

Capital Plans

The OTS addresses inadequate capital in savings associations as required by 12 CFR Parts 565 and 567, or through the impositions of an individual minimum capital requirement, or through other enforcement action.

The OTS regional director should provide copies of capital plans, revisions and modifications, requests for additional information, and proposed actions to the FDIC regional director for review and comment. Unless the FDIC regional director submits to the OTS regional director a written objection to the capital plan within thirty working days, the FDIC will normally not take backup enforcement action or action on divestiture plans that are contrary to the action taken by the OTS in approving a capital plan.

The FDIC regional director and the OTS regional director should resolve any differences with respect to capital plans. The regional directors should refer significant issues they cannot resolve to the OTS Deputy Director and the FDIC Director of Supervision. If such issues remain unresolved, the OTS may then approve the capital plan, but the FDIC may pursue backup enforcement action to resolve its concerns.

REFERENCES

Code of Federal Regulations (12 CFR)

§ 563.171 Frequency of Examinations

Office of Thrift Supervision Bulletins

TB 68 Supervisory Review, Appeal and Reconsideration Process and Ombudsman Matters

Closely Related Thrift Activities Regulatory Handbook Sections

Section 010	Handbook Use
Section 011	Program Use
Section 040	EDS/ROE
Section 045	Regulatory Action Data System (RAD)
Section 050	Regulatory Plan
Section 070	Overall Conclusions
Section 071	CAMELS Ratings

OTS Report of Examination Instructions Manual for Safety and Soundness Examinations

FFIEC Guidelines for Relying on State Examinations (June 27, 1995)

Examination Strategy, Scoping, and Management Program

Examination Objectives

To determine overall objectives for the on-site examination and ensure that the examination meets the objectives.

To determine the refined examination scope, the procedures to use, and the depth of testing and verification needed.

To determine personnel requirements, organize and coordinate human resources to attain optimum efficiency, and to supplement formal education programs through on-the-job training.

To facilitate clear and open communications between field staff, office staff, other regulatory bodies, and institution personnel.

To provide useful information for future planning, scoping, monitoring, and management.

Scoping Procedures

Wkp. Ref.

1. Prior to the examination, review the objectives, strategies, and preliminary scope outlined in the Regulatory Profile for the institution.

2. If applicable, coordinate with the OTS specialty (compliance, information systems, etc.) examiner in charge and the FDIC examiner in charge or FDIC regional office for joint scoping.

3. Review the most recent scoping materials available (those available in advance of the examination). This Handbook Section provides a list of scoping materials.

4. Ensure that the PERK requests on the summary schedule are tailored to the institution and type of examination. Send the PERK to the institution at least four weeks prior to the examination start date.

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5. Establish and document the detailed scope for the examination.

Note: For branch reviews, evaluate internal controls, management reporting, and audit coverage and findings before establishing scope. It may be necessary to perform only limited reviews of branches, particularly if credit files and other information can be sent to the office where the examination is being conducted.

6. Finalize staffing and examination dates.

7. Prepare assignments for assistants (before commencing the examination, if possible). If helpful, prepare time management forms. Contact assistants and inquire whether they have scheduled any time off or will be attending any training seminars during the estimated duration of the examination.

Examination Procedures

Level I

The EIC should perform the following procedures as soon as possible to ensure that the examination is properly managed.

1. Meet with the CEO or designee as soon as possible at the beginning of the examination. Refer to this Handbook Section for a list of recommended items to discuss. Notify the appropriate office when the examination has begun.

2. Discuss assignments with assistants including estimated time for completion. Determine that assistants are aware of the objectives stated in the Regulatory Profile and the specific activities included in the scope. Assist in establishing the scope for each of the assigned

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programs. Reiterate that material revisions to planned scopes should be approved by the EIC first.

3. Ensure the timely receipt and dissemination of information requested from management. Discuss problems with the appropriate contact person and establish revised deadlines for receipt of materials, if necessary.

4. Coordinate and oversee the review of materials obtained from the institution that might give an early indication of a need to change the scope (refer to this Handbook for a list of these materials). This review should include the following procedures:

   a. Review the institution's current Thrift Financial Reports (TFR) and Management Information Systems (MIS) reports and determine if there have been significant changes in the level of capital, lending or investment activity, earnings, or nonperforming assets.

   b. Review the minutes of the board of directors' meetings. Focus attention on significant changes in the institution's business activities (lending, investment, joint ventures, etc.). Assess the level of oversight performed by the directorate.

   c. Discuss with management any changes in key management, the directorate, or business activities that have occurred since the preceding examination. Also inquire as to any proposed changes or pending litigation that may affect earnings and capital.

   d. Determine through a review of correspondence, discussions with management, and other appropriate verification methods, if management corrected any problems related to the following areas:

      - Prior examination report comments and supervisory letters;
      - Eternal auditor's exceptions;
      - Internal auditor's exceptions; and
      - Any enforcement actions and directives.

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e. Determine if there are written policies governing key areas such as lending and investments. Evaluate the adequacy of new or revised written policies, procedures, and strategic plans. These guidelines should adequately address safety and soundness (including internal controls), profitability, and compliance with laws and regulations.

5. Make adjustments to the examination scope as necessary, but preferably as early as possible. Notify a supervisor if significant changes are anticipated in scope, staffing needs, duration, etc.

6. Throughout the examination:

- Review on a regular basis the workflow, findings, and actual versus budgeted time.
- Take appropriate steps to include on-the-job training.
- Discuss all items of concern with the assistants to ensure that the OTS presents accurate information at the closing conference with the CEO.
- Keep the supervisor and the CEO abreast of any developing significant issues.
- Determine that all examination work is being prepared in accordance with policies, including: work papers, interim reports, exception sheets, draft comments, report pages, time sheets, administrative reports, and transmittal file information. Refer to Thrift Activities Regulatory Handbook Section 070, Overall Conclusions, for a discussion of report content.

7. If you need additional verification, review, or analysis of any areas, complete or assign the completion of selected procedures from Levels I, II, and III for the particular area of review. (Refer to instructions for selecting Levels I, II, and III procedures in Thrift Activities Regulatory Handbook Section 011, Program Use.)

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8. Ensure that the examination meets the Examination Objectives of this Handbook Section.

Examination Closing Procedures

1. Schedule a closing conference and incorporate comments in the report. (For further instructions see Thrift Activities Regulatory Handbook Section 070, Overall Conclusions, and Section 071, CAMELS Ratings.) Notify all attendants of the closing conference date and time, preferably with the use of an agenda.

2. If appropriate, recommend any necessary administrative actions. Prepare a confidential memorandum if necessary.

3. If deemed constructive, provide a copy of Thrift Bulletin (TB) 68 to the CEO and discuss the process for resolving differences with examiners, including the TB 68 appeal process.

4. Complete the ROE and EDS (refer to Thrift Activities Regulatory Handbook Section 040, EDS/ROE and the ROE Instructions). Complete a time and planning summary to compare actual and budgeted hours. (You should verify all totals in the examination report and other reports with an adding machine or with the use of spreadsheet software.) Refer to Section 070, Overall Conclusions, and the ROE Instructions.

5. Ensure that the General File is completed.

6. Review work papers for completeness, proper indexing, date stamping etc. (The EIC may delegate this responsibility.) The EIC should have reviewed the work paper content and

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conclusions, and initialed all work papers, before finalization of the conclusions and comments.)

7. Prepare, if appropriate, evaluations of assistants. Recommend formal instruction and on-the-job experience that would further each of their careers. Discuss the evaluation with the individual and their supervisor, if applicable.

8. Complete a PERK summary schedule and summarize any other information that will be useful to the planning, scoping, and control of future examination activities and include in the General File.

9. Update the Regulatory Profile with any significant data obtained from the examination so that the plan is always current.

10. Transmit the completed report and return work papers and related files to the regional office in accordance with established procedures.

Examiner’s Summary, Recommendations, and Comments

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INTRODUCTION

This Section provides guidance on summarizing and effectively communicating conclusions to institution management and the board of directors. You develop conclusions from analyzing an institution's overall condition and viability through on-site examinations and other on-site and off-site regulatory reviews.

This section, written primarily from an examination perspective, refers to responsibilities of the examiner in charge (EIC). However, traditional titles, roles, and responsibilities vary among regional offices. Review your region's office structure and policy to determine where responsibility rests. Sometimes staff shares responsibility. For purposes of this section, we refer to "you" as the EIC and assistant examiners.

A primary goal of the regulatory process is to ensure savings associations operate in a safe and sound manner. For examinations and supervisory analyses to be most effective, you should identify the cause of any significant negative trends or problems and recommend a solution. A comprehensive yet concise analysis and summary of the institution's condition produce a more effective examination and allow directors and regulators to act promptly.

Your performance in this area is critical. You must be able to formulate conclusions and prioritize findings. Your ability to communicate findings to directors, management, and Office of Thrift Supervision (OTS) personnel significantly affects the regulatory process. Your findings help determine future strategies in the institution's regulatory profile and help directors correct weaknesses and capitalize on strengths.

This Section provides guidance in the following areas:

- Writing report comments.
- Developing conclusions and preparing comments.
- Formulating conclusions regarding the present condition and future prospects for the institution and for determining the institution's composite rating.
- Assigning CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk) ratings and an overall composite rating.
- Preparing a well developed, concisely written report of examination in plain language.
- Meetings with and presentations to institution representatives.
- Documenting off-site composite rating changes.

Report Comments

Examination reports should present a concise and balanced portrayal of an institution's condition and future prospects. Generally, report comments should include a synopsis of the work performed (scope) and your findings based on that scope. Your report conclusions should give the reader a clear understanding of the area reviewed.

A report of examination is factual and does not exclusively present negative or positive findings. It informs its readers, be they regulators, managers, or directors, of an institution's present condition and recommends a course of action to maintain or regain safe and sound operations.

You should identify strengths and weaknesses when necessary to provide a clear picture of the institution's prospects, or lack thereof, for future viability. Persons responsible for regulating institutions will need to have a balanced picture of its strengths and weaknesses.

Developing Conclusions and Comments

There are unique factors to consider when developing conclusions, comments, and ratings for each CAMELS component. Each comment should be complete and concise. Discuss each component's material strengths and weaknesses by identifying patterns and trends. Support your conclusions with appropriate analysis, including underlying deficiencies. State management's proposed corrective actions.

The following checklist will assist in developing report comments.

- Present the scope of the review.
- Clearly state your conclusions about risk, condition, and the effectiveness of management practices.
- Clearly identify patterns and trends, and their causes.
- Present comments in a meaningful order, discussing major strengths and weaknesses, with proper emphasis and tone accorded to individual topics.
- Identify problems relating to safety and soundness and substantive compliance issues.
- Include the deficient underlying practices when you note patterns of regulatory noncompliance.
- Support conclusions with appropriate analysis and prepare an effective summary that does not lose the reader in detail.
- Assess the effect of examination findings on future operations.
- Include a discussion of corrective action where necessary.
- Support the comments with work papers and other retained documents.
- Disclose the component rating.

Formulating Overall Conclusions

The development of substantive overall conclusions involves:

- Reviewing major findings from the examination (including trends).
- Considering the institution's operating environment (both internal and external factors).
- Converting ultimate determinations into ratings.
- Communicating results effectively.
- Facilitating the corrective action process.

There are both objective and subjective factors involved in a comprehensive analysis of the institution's present and expected future condition. You must weigh the significance of criticisms, deficiencies, and exceptions to offset strengths. This requires reviewing CAMELS comments and other findings for interrelationships. Whenever a practice or other factor materially affects safety and soundness, you must look at both the present and potential future effects.

Consider the following when evaluating the institution's present condition:

- Examiners' findings, including CAMELS comments and ratings, trends, patterns, exceptions, and other observations.
- Patterns of regulatory noncompliance, deficient procedures, and other factors causing noncompliance.
- Interrelationships between findings noted for each CAMELS component.
- Effectiveness of the corrective actions initiated to resolve earlier deficiencies.

Evaluate an institution's future condition by making an assessment of the following areas:

- Adequacy of policies and procedures, personnel, information systems, books and records, accounting and other internal controls, audit function, and asset review function.
- Overall compliance with laws, regulations, and policies.
- The board of directors' and management's ability to take prompt corrective actions.

- Strategic planning and the written business plan, including changes expected in asset and liability composition, organizational structure, growth, etc.
- Management's ability to perform according to the business plan.
- Competitive, economic, and regulatory conditions. Include: management's ability to assess market conditions, trends, composition, and expected changes in economic conditions, competitive factors, and the regulatory environment.

One goal of the regulatory process is to prevent problems from developing or escalating in the future. Therefore, early identification of risk or weaknesses in management practices is key. Support any projections with adequate facts and analyses.

When developing a conclusion about the institution's future prospects, consider existing systems, policies, and procedures; the business plan; corrective action; projections for operating performance; management ability; market and economic factors.

Assigning Component and Composite Ratings

OTS uses a standardized system for rating savings associations it supervises. OTS rates thrifts according to the individual CAMELS components of Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk. Based on a quantitative and qualitative review of these components, OTS assigns an overall composite rating.

After formulating the conclusions, you can begin the rating process. Since it is difficult to provide a specific formula for this process, experience and judgment are critical. It is inappropriate to simply average the individual CAMELS ratings or use standard formulas. A high degree of correlation should exist between the composite rating and the component ratings. The composite rating should support objective information in the Examination Conclusions and Comments page, the CAMELS comments, and the work papers.

You should refer to Thrift Activities Regulatory Handbook Section 071, CAMELS Ratings, for a discussion of the composite and component rating criteria and disclosure to thrift directors.

OTS personnel use the ratings for a variety of purposes:

- To reflect trends for a particular institution.
- To make comparisons with peers.
- To assess the condition of the industry.

The CAMELS ratings help determine appropriate strategies including the following:

- Frequency and scope of off-site and on-site analysis.
- Enforcement actions.
- Meetings with institution representatives.
- Analyzing applications (i.e., mergers and acquisitions and subordinated debt issuance).

Because ratings determine a variety of critical decisions, a systematic and logical analysis is essential. While objective analysis and findings primarily determine ratings, there is some reliance on subjective factors, too.

REPORTING RESULTS

Regional offices use the following three vehicles to communicate findings to institution directors:

- The Report of Examination.
- Meetings with institution representatives.
- The supervisory letter (for off-site changes in the composite rating).

Report of Examination (ROE)

Refer to the Report of Examination (ROE) Instructions and the Thrift Activities Regulatory Handbook to prepare safety and soundness examination reports.

Examination Conclusions and Comments

The Examination Conclusions and Comments page of the ROE should be the focal point for reporting conclusions from any examination or review. To facilitate timely corrective action, direct report comments to the institution's board of directors even though the document remains OTS property. Complete the Examination Conclusions and Comments page according to the ROE instructions.

Consider the following primary factors when developing this page:

- Report items that are material and that relate to safety and soundness.
- Present information that provides the reader with a clear understanding of the overall condition, adequacy of management practices, causes of major problems, and recommendations for remedial action.
- For regulatory violations, include only material patterns of noncompliance, along with the identified root(s) of the problems(s). A simple listing of violations is usually ineffective as a regulatory measure, particularly in the case of an isolated incident or error. While it is appropriate, in certain situations, to include isolated violations in the report, you should not bring them forward to the Examination Conclusions and Comments page unless they are significant.
- State conclusions and comments briefly. Do not repeat analysis or support provided elsewhere in the report.
- Demonstrate how items interrelate. Do not simply list them.
- Document all conclusions in report comments, work papers, or other records.

Present conclusions in an order that first describes matters requiring immediate follow-up supervisory action. The severity of a problem will dictate its order of presentation. Concisely state how the problem affects the institution's other activities and any mitigating circumstances.

Address the following items on the Examination Conclusions and Comments page:

- The type of examination and whether there was a holding company examination. If applicable, state that there is a separate holding company report.
- The asset size of the institution, principal lines of business, and the date of the financial statements in the ROE.
- A statement of the scope of the examination or supervisory review.
- A concise statement of your conclusions about the overall condition of the institution.
- A brief discussion of the CAMELS components (if applicable) and positive and negative attributes of other significant items reviewed. Focus on patterns, trends, causes of problems, and projections for future operations.
- Identification of "troubled" condition, if applicable.
- Disclose the composite CAMELS rating if assigned, refer to the definition of the assigned rating, and explain the correlation between the institution's circumstances and the rating.
- A statement regarding the extent of compliance with any outstanding enforcement actions or mandatory PCA restrictions, if any.
- A reference to necessary corrective action(s) as described on the Matters Requiring Board Attention page.

If necessary, you may use the ROE cover page letter to expand on examination findings. Do not merely restate examination findings in the ROE cover page letter.

Plain Language

You should write the ROE in plain language using the following principles:

- Simple everyday words except for necessary technical terms.

- Short sentences that are direct and to the point, with phrases in the active voice.
- Identifying the "doer." For example, in this Handbook we use "you" to identify the examiner.
- Parallel ideas expressed in parallel constructions.
- Indented lists like this one, preceded by bullets or numbers.
- Descriptive headings that provide focus to subjects and break up long pages of text into manageable segments.

You may also refer to the OTS Style Guide available on the OTS Intranet under Tools.

Meetings with Institution Representatives

Meeting with institution representatives regularly during the examination will allow you to do the following:

- Introduce examiners to institution staff responsible for providing additional information.
- Discuss the scope of the examination at the start of the examination.
- Discuss preliminary findings and whether there is a need to expand the scope.
- Discuss results of the institution's internal asset reviews, its asset classifications, and any differences between the regulator's asset classifications and those of the institution.

After the on-site examination, meet with the institution's senior management for a post examination discussion concerning your conclusions and recommendations. Normally you would meet after preparing the preliminary draft examination report. The EIC and CEO determine the appropriate date and time. The EIC is responsible for notifying any other regulatory personal who should attend. You should prepare an agenda for the attendees, and any exhibits that will strengthen or clarify the presentation.

The purpose of the meeting is to discuss examination findings, elicit management's response to corrective action, verify conclusions, and answer management's questions. This meeting gives you an opportunity to discuss strengths and weaknesses noted and recommend corrective action if necessary.

Regulatory personnel should meet with the institution's board of directors when deficiencies are serious. When discussing the need for corrective action, be specific and agree on a time frame. Refer to Thrift Activities Regulatory Handbook Section 320, Meetings with the Board of Directors, for additional guidance. Although it is not necessary to meet with the board of directors after each examination at institutions with no serious deficiencies noted, we encourage regulatory personnel to meet periodically with the board after selected examinations to maintain an open line of communication.

Disclosing Ratings

You will disclose component ratings and composite CAMELS ratings at exit conferences with senior management and, when appropriate, the board of directors. Obtain sufficient concurrence from regional management, so that the ratings you disclose are final, or subject to revisions only in rare instances. If the ratings are subject to further review, let thrift management know that the ratings are not final.

We expect you to discuss the elements considered in assigning each component rating and those considered in assigning the overall rating. You should indicate that a careful evaluation of the institution's managerial, operational and financial performance and their compliance with laws and regulations determines the composite rating.

Supervisory Letter

When the regional office changes the composite ratings off-site, send a supervisory letter to the board of directors to notify them of the change. A change in the composite rating may result from changes in the institution's operating strategies or conditions. An on-site review may be appropriate when conditions warrant a downgrade in rating. When the composite rating changes, we advise evaluating the need to change all six CAMELS component ratings. Include in the supervisory letter a prohibition against outside disclosure and explain why the rating changed.

REFERENCE

Office of Thrift Supervision

OTS Thrift Safety and Soundness Report of Examination Instructions

Overall Conclusions
Program

Examination Objectives

To formulate conclusions regarding the risks, condition, trends, management practices, and future prospects of the thrift.

To formulate conclusions on the safety and soundness of the thrift and propose supervisory action, if needed.

To record management's response to examination findings, conclusions, and proposed corrective action.

To effectively communicate conclusions and recommendations, both orally and in writing, in the Report of Examination according to common core ROE instructions and plain language principles.

Examination Procedures

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1. Review analyses, comments, exceptions, and conclusions from the work papers, and perform the following:

   - Resolve any contradictory conclusions. Support all conclusions with facts obtained during the examination.
   - Determine the significance of the findings related to safety and soundness and overall regulatory compliance.
   - Discuss findings with appropriate institution personnel and verify conclusions as appropriate.

   ____ __________

2. Review the draft CAMELS comments. Talk with assisting examiners about their overall CAMELS observations and findings applicable to the comments, and determine whether conclusions are reasonable.

   ____ __________

3. Revise CAMELS comments so that they fairly represent examination results according to ROE instructions. Ensure conclusions are well supported in work papers and comments include any significant items noted in work papers. The tone and content of each comment should be concise and appropriate, as outlined in the Handbook.

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4. Review the preliminary CAMELS component ratings and meet with assisting examiners. You should consistently apply the standard criteria set by OTS for determining ratings. Follow definitions and instructions pertinent to the rating system to ensure national consistency.

5. If necessary, adjust the CAMELS component ratings using the instructions in Thrift Activities Regulatory Handbook Section 071, CAMELS Ratings. Review CAMELS comments again to ensure that they are consistent with the component ratings assigned.

6. Develop overall conclusions and prepare the Examination Conclusions and Comments page. Ensure the report is written in plain language.

7. Determine the composite rating by weighing the importance of various criteria used to develop conclusions. To ensure national consistency, you should follow the rating instructions in Thrift Activities Regulatory Handbook Section 071.

8. Review the Examination Conclusions and Comments page again to ensure the tone and content supports the assigned composite rating.

9. Discuss findings with management, typically the CEO. We recommend that you use an agenda. Discuss at least the following topics:

   - The purpose of the meeting.
   - All items that you might include in the examination report.
   - Overall conclusions regarding the institution.
   - Management's corrective action responses.

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- Composite and component ratings.

10. After the meeting, correct any items in the ROE that are inaccurate, misleading, or misinterpreted.

11. The Matters Requiring Board Attention page should include corrective actions, if appropriate. These include specific recommendations to correct deficiencies listed in the report, or recommendations for: supervisory agreements, consent agreements, cease-and-desist orders, receiverships, conservatorships, civil money penalties, and criminal referrals to appropriate agencies. For suspected violations of criminal statutes, the EIC should refer to Thrift Activities Regulatory Handbook Section 360, Fraud/Insider Abuse.

12. Provide any information to the regional office that will be useful for revising the regulatory profile.

13. Prepare the ROE cover page letter, if necessary, in accordance with regional office policy.

14. Prepare to meet with the board of directors regarding findings. Refer to Thrift Activities Regulatory Handbook Section 320, Meetings with the Board of Directors, for instructions.

15. Ensure that your review meets the Objectives of this Handbook Section.

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Overall Conclusions
Program

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Examiner's Summary, Recommendations, and Comments

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INTRODUCTION

OTS uses the CAMELS rating system to evaluate an institution's overall condition and performance by assessing six rating components. The six components are Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk. OTS then assigns each institution a composite rating based on the examiner's assessment of its overall condition and level of supervisory concern. The rating system was revised in December 1996. The four federal banking agencies updated the rating definitions and addressed changes in the financial services industry and in supervisory policies and procedures that occurred since the rating system was first adopted in 1979. The Office of Thrift Supervision (OTS) adopted the revised Uniform Financial Institutions Rating System (UFIRS) effective for all safety and soundness examinations with start dates after January 31, 1997.

Aggregate rating information enables the public and Congress to assess the condition of the savings and loan industry. Because each of the banking regulatory agencies adopted this uniform rating system, Congress can readily compare composite rating data for all types of insured financial institutions.

Changes to UFIRS

The revised rating system places additional emphasis on management's effectiveness in identifying, measuring, monitoring and controlling risk. The interagency group made two principal enhancements to update the rating system while retaining its basic framework. First, the evaluation of interest rate and other non-credit financial risks was moved from the Liquidity and other components to a new sixth component called "Sensitivity to Market Risk." Thus, the revised rating system acronym is CAMELS. The new "S" component rating addresses the degree that changes in interest rates, commodity prices, and equity prices could adversely affect the institution's earnings or economic capital. The new component, while broad in scope, only focuses on those elements that are relevant to the thrift being examined. For example, foreign exchange and price risks may not be relevant to some thrifts and thus their "S" component rating will primarily focus on interest rate risk.

Another noteworthy change is that the definitions for composite 1-, 2-, and 3-rated institutions establish more explicit guidance for the component ratings:

- For composite 1-rated institutions, all components should generally be rated 1 or 2.
- For composite 2-rated institutions, component ratings should normally be no worse than 3.
- For composite 3-rated institutions, none of the component ratings should be worse than 4.

Such guidance, while not an absolute requirement, is more specific than previous CAMEL rating guidance. The revised UFIRS statement is the definitive statement on safety and soundness ratings. (See Appendix A.) The remainder of this handbook section expands on, or highlights certain parts of the policy statement as it applies to thrift institutions.

Composite Ratings

The composite rating is a qualitative assessment by the agency of the institution's condition and the agency's overall level of supervisory concern. Although the composite rating assigned to the thrift should normally have a close relationship to the individual CAMELS component ratings, you should not derive the composite rating merely by computing an arithmetic average of the component ratings. Such a simplistic, mechanical approach will not reflect the true condition of the savings association; nor will it indicate the appropriate supervisory actions.

You should include in the Examination Conclusions and Comments page of the report of examination (ROE) the following items:

- A discussion of the institution's composite rating.
- A reference to (not a repetition of) the applicable rating definition.
- A description of the institution's particular circumstances that affected the rating as defined.

You must ensure that the report comments and work papers support the assigned ratings.

One of the principal objectives of the CAMELS rating process is to identify, through the composite rating, those thrifts that pose a risk of failure and merit more than normal supervisory attention. Thus, you should give more weight to individual CAMELS criteria that more strongly affect the condition and viability of the thrift.

The composite CAMELS rating, the CAMELS component ratings, and supporting documentation all play an important part in the regulatory process in support of any necessary enforcement action.

OTS uses an institution's composite rating as one of the factors to determine whether the institution should be designated as being in "troubled condition." Any thrift that has a composite CAMELS rating of 4 or 5, is designated in troubled condition by OTS. Other qualifiers of "troubled condition" are defined in 12 CFR § 563.555. These thrifts are subject to greater regulatory scrutiny and restrictions, such as requirements to receive prior approval before engaging in certain activities.

When examining a thrift in troubled condition, you should consult the regulatory plan, supervisory correspondence, the previous examination, and any other pertinent information to determine the operating restrictions to which a thrift is subject. You must then analyze the institution's operations and ensure that it is in compliance with all restrictions. For further information regarding operating restrictions, refer to Handbook Section 370, Enforcement Actions.

The CAMELS ratings also support OTS's differential regulation policy. The composite CAMELS rating establishes both the OTS and the Federal Deposit Insurance Corporation (FDIC) fee assessment levels and determines the levels of supervisory oversight and restrictions. This policy provides tighter restrictions for thrifts with worse composite ratings and other factors, and is evident in the following guidance:

- Regulatory Bulletin (RB) 18 series (Enforcement Policy).
- RB 3b (Growth Restrictions).
- OTS asset-based assessment regulation at 12 CFR § 502.1.
- OTS audit regulation at 12 CFR §562.4.
- OTS transactions with affiliates regulation at 12 CFR § 563.41.
- OTS capital regulations at 12 CFR § 565.4.
- OTS directors regulation at 12 CFR §§ 563.550 through 563.590.
- FDIC risk-based deposit insurance assessment regulation at 12 CFR Part 327.

Component Ratings

As the introduction states, component ratings indicate an institution's performance in the six key performance groups that are common to all institutions.

Capital Adequacy

Maintaining an adequate level of capital is a critical element for depository institutions. While meeting regulatory capital requirements is a key factor in determining capital adequacy, the institution's operations and risk position may warrant additional capital beyond the minimum regulatory requirements. You should determine whether capital is adequate in relation to the risk profile and operations of the thrift. In addition, you should evaluate capital levels in relation to future needs.

Since maintaining a sufficient level of capital is critical for an institution to maintain operations, you should appropriately weigh the importance of capital on the viability of the thrift when formulating the composite rating. You should also consider the institution's dividend payout policy and practice. You should rate an institution's capital adequacy considering all criteria cited in the UFIRS statement.

<u>PCA Levels</u>

Note that, in general, an institution in any of the three lower-tier Prompt Corrective Action (PCA) categories warrants a 4 or 5 Capital component rating. A capital rating of 4 is appropriate if the thrift is undercapitalized or significantly undercapitalized but asset quality, earnings, or interest rate risk problems will not cause the thrift to become critically undercapitalized in the next 12 months. Also, a capital rating of 4 may be appropriate for an institution that does not have sufficient capital based on its capital level compared with the risks present in its operations, even though the thrift may meet the minimum regulatory requirements.

An institution is presumed to warrant a 5 rating if it is "critically undercapitalized," or has significant asset quality problems, negative earning trends, or high interest rate risk exposure that will cause the thrift to become critically undercapitalized within the next 12 months.

See the Capital Chapter of this Handbook for more detailed instructions for reviewing capital adequacy.

Asset Quality

An accurate evaluation of an institution's asset quality can be one of the most important products of the examination. The asset quality rating reflects the extent of credit risk associated with the loan and investment portfolios, real estate owned, other assets, and off-balance sheet risks as well as the institution's ability to manage those risks. The evaluation of an institution's asset quality is dependent on the institution's policies and procedures relating to loan underwriting and asset procurement, the proper classification of assets, and the adequacy of the institution's valuation allowances.

The component and composite ratings demonstrate the level of supervisory concern over an institution, its activities, and its performance. When asset quality is in doubt because of excessive or inadequately controlled risk, the institution's asset quality component rating should reflect this concern. In order to attain a 1 or 2 Asset Quality component rating, an institution must fully control its credit risk. If an institution has a high exposure to credit risk, it is not sufficient to demonstrate that the loans are profitable or that the institution has not experienced significant losses in the near term. Management must demonstrate that it has identified credit risks, measured the potential exposure to loss, established systems to monitor such risk on an ongoing basis, and has adequate measures in place to limit and control those risks. Otherwise, a significant supervisory concern will exist relative to the institution's asset quality.

Management

The management rating is a reflection of the performance of the entire management team of the thrift. This includes the board of directors and all levels of management. The rating is an assessment of management's overall effectiveness.

The directors have two basic responsibilities:

- Provide for effective thrift management.
- Establish objectives and policies appropriate for their thrift.

Directors are also responsible for ensuring that management effectively implements these policies and initiates corrective action when necessary to ensure adequate management control and results.

You should base your assessment of management on a historical, current, and prospective evaluation of management's effectiveness in addressing problems the thrift encounters. Since financial performance is the primary indicator of the viability of an institution, the thrift's financial performance will strongly influence the management rating.

Often a new management team or a new key senior executive officer assumes the administrative responsibility of a thrift in troubled condition. You should not rate new management too highly based on performance projections, newly implemented policies and procedures, or management's aggressive attempts to solve those problems. The management rating should reflect the actual results of management's efforts. As such, the management component rating should be conservative until new management demonstrates the ability to actually improve the institution's condition, or at a minimum, its policies, procedures, and key operational areas. For example, new management improved loan underwriting, collections, and the Internal Asset Review (IAR) functions on a consistent basis. Unless management implements such broad improvements, the management rating should generally be no higher than a 3 for an institution with poor operating performance.

You must be keenly aware of unsafe and unsound practices such as self-dealing that results in unofficial compensation to management or directors. Self-dealing may result from actions undertaken directly by management or directors, or by their agents. Business dealings with insiders should be for the benefit of the thrift and on terms substantially the same as those with third parties. Self-dealing provides grounds for an unsatisfactory management rating.

Earnings

You must determine whether earnings are sufficient for necessary capital formation. An institution should have minimum earnings sufficient to absorb losses without impairing capital. Quality (stability) and composition (source) of earnings are important criteria. The thrift cannot rely on income that is nonrecurring, such as gains on the sale of portfolio loans, to maintain profitability. You should consider the extent to which extraordinary items, such as nonrecurring securities transactions and tax effects contribute to net income.

In some cases, thrifts are able to sustain volume and stable earnings from noninterest sources of income; for example, mortgage banking operations. In these thrifts (as well as all other thrifts), you should use professional judgment and analyze the stability and sufficiency of noninterest earnings. This includes the institution's ability to react quickly to changing economic conditions, such as a decline in mortgage originations.

You should consider the adequacy of transfers to the general and specific valuation allowances; if the thrift needs more allowances, earnings will be negatively affected.

You should also consider the institution's operating risks to determine if its earnings position is stable and sufficient. For example, if an institution's interest rate risk management is inadequate, the institution's earnings may be adversely affected by a change in market interest rates.

Liquidity

OTS measures liquidity in relation to an institution's level of liquid assets, its outside sources of funds, and the adequacy of its funds (or cash flow) management practices. Historically, most thrifts have held sufficient liquid assets. OTS-supervised thrifts generally rely upon liquidity available from secured lines of credit with the Federal Home Loan Banks (FHLBs). As long as the thrift's performance is sufficient to allow it to maintain a favorable credit standing with the FHLBs, and as long as the FHLBs also have adequate liquidity, thrifts can continue to confidently rely upon them for their liquidity needs.

Sensitivity to Market Risk

The UFIRS bases the sensitivity to market risk component rating on two dimensions:

- The institution's level of market risk.
- The quality of the institution's practices for managing market risk.

Because few thrift institutions have significant exposure to foreign exchange risk or commodity or equity price risks, OTS generally assesses interest rate risk as the only form of market risk. You must assess both dimensions and combine those assessments into a component rating.

You must base your conclusions about an institution's level of interest rate risk – the first dimension for determining the S component rating – primarily on the interest rate sensitivity of the institution's net portfolio value (NPV). You must pay primary attention to two specific measures of risk: Interest Rate Sensitivity Measure and Post-shock NPV Ratio. (See the TB 13a glossary for definitions.)

- Interest Rate Sensitivity Measure. This measure by itself, may not give cause for supervisory concern when the institution has a strong capital position. Because an institution's risk of failure is inextricably linked to capital and, hence, to its ability to absorb adverse economic shocks, an institution with a high level of economic capital, that is, NPV, may be able safely to support a high sensitivity measure.

- Post-shock NPV Ratio. This ratio is a more comprehensive gauge of risk than the sensitivity measure because it incorporates estimates of the current economic value of an institution's portfolio, in addition to the reported capital level and interest rate risk sensitivity. There are three potential causes of a low, that is, risky, post-shock NPV ratio:

  — low reported capital
  — significant unrecognized depreciation in the value of the portfolio
  — high interest rate sensitivity.

Although the first two situations may cause supervisory concern and receive attention under the portions of the examination devoted to evaluating Capital Adequacy, Asset Quality, or Earnings, they do not necessarily represent an interest rate risk problem. Only when an institution's low post-shock NPV is, in whole or in part, caused by high interest rate sensitivity is there suggestion of an interest rate risk problem.

Refer to TB 13a (Section IV, Table 1) for the guidelines to determine the level of interest rate risk. Use these risk levels as starting points in your ratings assessments; however, you have broad discretion to exercise judgment. TB 13a provides these risk levels as guidance; they are not mandatory.

OTS produces quarterly estimates of the sensitivity measure of the post-shock NPV ratio for each thrift that files TFR Schedule CMR. You can find these estimates in the Interest Rate Risk Exposure Report for the thrift.

In drawing conclusions about the quality of an institution's risk management practices – the second dimension of the S component rating – you must assess all significant facets of the institution's risk management process.

Consider the following eight factors when assessing the quality of an institution's risk management practices:

- Quality of oversight by the board and senior management.
- Prudence of board-approved IRR limits.
- Adherence to IRR limits.
- Quality of system for measuring NPV sensitivity.
- Quality of system for measuring earnings sensitivity.
- Integration of risk management with decision-making.
- Investments and derivatives including risk management policies and procedures.
- Institution's size, complexity, and risk profile.

Although TB 13a (Table 2) provides guidelines on how to combine your assessment of these two dimensions into a component rating, you must exercise judgment in assigning ratings based on the facts you encounter at each institution. TB 13a (Section IV) provides a non-exhaustive list of factors you might consider in applying the S rating guidelines to a particular institution.

Thrift Performance Evaluation and CAMELS Rating Assignments

The Uniform Thrift Performance Report (UTPR) provides percentile rankings for many measures of thrift performance as compared to peer performance. Use the Thrift Monitoring System (TMS) Group Query process to find the CAMELS composite and component ratings of other thrifts with similar key ratios. These tools are useful in comparing a thrift's performance with that of its peers to assign ratings that are consistent with thrifts having similar ratios. However, since the composite CAMELS rating is an indicator of the overall health and viability of an institution, it is important that you rate thrifts on their absolute performance rather than only against regional or state peer performance. Thrifts in some states or regions may perform better than peer averages or medians, but perform poorly in absolute terms or when compared with peer averages or medians of other regions. Peer performance in such cases would not necessarily reflect thrifts that were being operated in a safe and sound manner. Rather, those averages could reflect substandard performance. The CAMELS ratings should accurately reflect the condition of a thrift, regardless of local or regional peer performance.

An institution's performance cannot be measured solely in numbers. The mere fact that an institution meets its minimum regulatory capital, liquidity, and other regulatory requirements does not guarantee that its condition is viable. Therefore, you must use professional judgment and consider both qualitative and quantitative criteria when analyzing an institution's performance.

You should consider the following items to determine the CAMELS composite and component ratings:

- Quality of management and the board of directors.
- Quality and composition of the asset portfolio.
- Risks inherent in the business activities.
- Financial data.

Further, since financial numbers are lagging indicators of an institution's condition, you must also conduct a qualitative analysis of current and projected operations when assigning CAMELS ratings. You should weigh the analysis of quantitative and qualitative data to determine the rating for each CAMELS component.

An institution with a high level of classified assets, a decreasing trend in foreclosures and delinquencies, and adequate general valuation allowances, loan underwriting, and an IAR program may merit a higher asset quality rating than an institution with the same level of classified assets, an increasing trend in foreclosures and delinquencies, and inadequate general valuation allowances, loan underwriting, and IAR program. Qualitative criteria related to these ratios may mitigate the institution's condition and, hence, the rating. You should consider all significant criteria, both qualitative and quantitative, when assigning CAMELS ratings.

You must consider all applicable information reviewed under each CAMELS component on a scale of 1 to 5. You must then make a qualitative assessment of the information reviewed for each CAMELS component to assign the ratings.

OTS structured this Handbook and the ROE around the CAMELS components. An analysis of an institution's overall soundness cannot be made without adequate consideration of all six areas and their interrelationships. This Handbook Section briefly presents the main areas you must review in order to assign the six CAMELS component ratings and the composite rating. The remaining chapters in this Handbook provide detailed instructions for the review of each CAMELS component. You should follow the examination procedures within each of the chapters as required by the examination scope to develop the CAMELS component ratings.

Consistency in CAMELS Rating Assignments

It is essential that OTS apply CAMELS ratings on a nationally consistent basis. Inconsistencies in assigning CAMELS component or composite ratings may result in confusion and degrade the integrity of the supervisory process. When OTS consistently applies CAMELS ratings, the condition of the thrift can be compared between the previous examination and the most recent examination. Furthermore, thrifts can be compared on an intraregional and a national basis using TMS Group Query reports sorted by key ratios or imported into a spreadsheet and sorted by component ratings. To ensure consistency in the CAMELS rating process, you must have a thorough understanding of the criteria to assign the different CAMELS component and composite ratings.

Maintaining and Updating the CAMELS Ratings

It is also essential that regional offices monitor new developments for each thrift and update the ratings, as needed, so that the rating is always a current indicator of the institution's condition. (Refer to the procedures for off-site CAMELS ratings at the end of this Handbook Section.) Maintaining these ratings requires periodic monitoring with an emphasis on the criteria supporting the CAMELS ratings for the thrift. For this reason, it is imperative that you document the significant points supporting the CAMELS rating.

Deterioration or significant changes in the institution's operations or condition may indicate a need for some special supervisory attention. Supervisory attention may include a telephone inquiry or written request for additional information, a special limited examination, or a regular examination. Any changes in the criteria that support the current ratings or any new developments may require a change in the CAMELS ratings and the supervisory treatment needed.

Since ratings affect the institution's assessment and supervisory treatment, they must be kept current. Analyze and adequately document any updates to the ratings. The rating reported to a thrift must always be the most recent rating based on all sources of information.

Documentation and Support

Given the importance of the CAMELS ratings, it is critical to clearly show and support how you determined these ratings. You should review ROE ratios, UTPR schedules, and customized TMS reports and use them to concisely document and support the analysis. You may also find these reports useful in assimilating and reviewing work paper conclusions and organizing your thoughts before drafting the ROE.

Disclosure of CAMELS Ratings

Since 1988, OTS disclosed composite or overall examination ratings to each institution’s management and board of directors. Concurrent with the adoption of the new UFIRS rating system, OTS began disclosing the CAMELS component ratings with the CAMEL composite rating in the ROE. Disclosure of the CAMELS component ratings encourages a more complete and open discussion of examination findings and recommendations between examiners and thrift management. Further, disclosure of the CAMELS component ratings in addition to the composite rating provides management with a better understanding of how OTS derives the composite rating. Disclosure also enables management to better address any weaknesses in specific areas before OTS finds it necessary to downgrade the institution’s overall composite rating. Use the following rating disclosure procedures for all safety and soundness examinations, including joint and concurrent examinations, that OTS conducts.

You must disclose the assigned composite rating in accordance with OTS’s ROE instructions. Add the component rating to the top left corner of each ROE core component page. Report comments on the Examination Conclusions and Comments page and on other related schedules throughout the report should fully support the composite and component ratings assigned. The individual core page for a component rating should continue to contain a clear and thorough discussion of that component. You should support component ratings with selected use of statistics. Use language that is clear and informative, appropriate in tone, and explain your assignments, conclusions, and reasoning.

Management Discussions

You must disclose CAMELS composite and component ratings at exit conferences with senior management and, when appropriate, the board of directors. You should obtain sufficient concurrence with the ratings from regional management, so that the component ratings disclosed are final, or subject to revisions only in rare instances. If the ratings are subject to further review, you should disclose to thrift management that the ratings are not final. Each region has office procedures to implement this policy.

During the discussion with management, you should discuss the criteria you considered in assigning each component rating as well as the overall composite rating. You should indicate that you based the composite rating on a careful evaluation of the institution’s managerial, operational and financial performance, and compliance with laws and regulations. You should clarify that you did not base the composite rating on an arithmetic average of the components, but on a qualitative analysis of the criteria comprising each component, the interrelationship between components, and, more importantly, the overall level of supervisory concern.

The quality of management is the single most important element in the successful operation of a thrift, and is usually the factor that is most indicative of how well the institution identifies, measures, monitors, and controls risk. For this reason, you should take sufficient time to explain to senior management and, when appropriate, to the board of directors, the criteria you considered in assigning the management component rating, and the meaning of the rating. Your written comments in support of the management rating should include an assessment of the effectiveness of existing processes to identify, measure, monitor, and control risk. Finally, you should remind management that the CAMELS composite and component ratings disclosed in the examination report remain subject to the confidentiality rules imposed by 12 CFR Part 510 of the OTS Regulations. This includes the verbal disclosures made at the conclusion of the examination.

REFERENCES

Code of Federal Regulations (12 CFR)

OTS Regulations

§502.1	Asset-based Assessments
§562.4	Audit of Savings Associations and Holding Companies
§563.41	Loans and Other Transactions With Affiliates
§563.550	Additions of Directors and Employment of Senior Executive Officers
§565.4	Capital Measures and Capital Category Definitions

FDIC Regulations

Part 327	Assessments

Office of Thrift Supervision Bulletins

RB 3b	Policy Statement on Growth for Insured Institutions
RB 18	General Enforcement Policy Series
TB 13a	Management of Interest Rate Risk, Investment Securities, and Derivative Activities
TB 69	Revised Rating System; Disclosure of Component Ratings (the UFIRS is attached)
TB 69-1	Common Questions on the Revised UFIRS (the FFIEC document is attached)

Other References

OTS Report of Examination Instructions Manual

FFIEC Press Release, “Uniform Financial Institutions Rating System,” December 19, 1996

OTS Transmittal 166: Regulatory Citations to UFIRS

CAMELS Ratings
Program

Examination Objectives

To consider all significant financial, operational, and compliance performance measures for an institution and assign CAMELS ratings that accurately reflect the institution's condition and viability.

To clearly support the CAMELS ratings in the examination report and enable OTS to initiate corrective action with the institution's directors and management.

To provide the institution's management and the board of directors with CAMELS ratings that signify the OTS assessment of the institution's overall condition.

Examination Procedures

The following procedures depend on information obtained from all phases of the examination and from all off-site sources. The examiner in charge (EIC), or designee, should complete the following procedures for developing the CAMELS ratings during the final stages of the examination.

On-Site CAMELS Ratings

Note: If the EIC completed the overall conclusions program, Section 070 of this Handbook, on-site steps are substantially complete.

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1. Review analyses, exceptions, and conclusions in the work papers for each CAMELS component. Support all conclusions with objective information. Resolve any contradictory conclusions.

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2. Review assisting examiners' comments on individual CAMELS criteria. If necessary, make adjustments to ensure that comments are comprehensive and to eliminate any duplication. If the EIC is aware of other criteria that are not known to assisting personnel, the EIC should determine if these criteria are relevant and whether or not to include the comments.

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3. Review the proposed corrective actions related to any violation or exception to ensure it is appropriate.

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4. Review the preliminary CAMELS component ratings that assistant examiners recommend. Discuss the recommendations with assistant examiners to ensure the accuracy of their interpretations. Ensure that assistant examiners provided well-supported conclusions and opinions. Ensure that assistant examiners consistently applied the standard criteria set forth in this Handbook Section for determining and weighing the CAMELS criteria and assigning the CAMELS component ratings.

5. If necessary, adjust the CAMELS ratings so that they accurately and objectively present the institution's performance in each CAMELS component. Document the basis for each rating. Include the ROE ratios as well as any other pertinent ratios. Also include the most significant points supporting each CAMELS rating.

6. Weigh the relative importance of the various criteria considered when developing the CAMELS component ratings, and analyze their effect on the overall condition of the thrift. Determine the composite rating, applying the standard criteria set forth in the UFIRS statement following this Handbook Section. Clearly support the composite rating with the facts and comments within the ROE.

7. Prepare the Examination Conclusions and Comments page. Refer to the ROE Instructions manual for a list of the elements you should include on this page.

8. Discuss findings with management. Refer to Section 070, Overall Conclusions, for further instructions for meeting with thrift management.

9. Review the comments again to ensure consistency with the assigned ratings. Finalize the CAMELS ratings and comments after a thorough review. Ensure that the assistant examiner correctly completed the Examination Data System (EDS) ratings section.

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10. Ensure your review meets the Examination Objectives of this Handbook Section.

Off-Site CAMELS Ratings

Supervisory managers, analysts, or other staff should complete the following procedures as applicable when analyzing and updating CAMELS ratings off-site:

Note: Any off-site CAMELS rating updates should be done using the Type 22 Examination Report, “Off-Site Monitoring.”

1. Review the most recent examination report and the Regulatory Profile for the institution to identify areas of concern.

2. Analyze reported financial information to determine current trends and any new areas of concern, with an emphasis on the period since the last examination.

3. Review any applications the thrift submitted since the last rating to determine whether there are any material changes in the structure or business plan.

4. Review correspondence between the thrift and OTS to learn the status of significant issues arising since the most recent examination. Verify, to the extent possible, through a review of the financial statements and other reports that the thrift is correcting any problem areas.

5. Review the most recent external audit report, the certified public accountant’s management letter addressing internal control issues, and the institution’s response to that letter to determine if management corrected all reported internal control deficiencies.

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6. If necessary, contact the institution to verify specific facts or address concerns.

7. Identify any changes in the institution’s condition and operating practices. Determine if a change in a CAMELS component or composite rating more appropriately reflects the condition of the thrift.

8. Determine the need for and recommend, if necessary, a supplemental or full-scope examination or an on-site review of areas that you cannot adequately analyze off-site.

9. Recommend any change in the CAMELS component or composite ratings to the supervisory manager or other appropriate manager in the regional office. Support any recommendation for change with a narrative memorandum and documented analysis explaining and supporting the reasons for the change.

10. If the regional office approves a change in a composite or component CAMELS rating, prepare a supervisory letter or memorandum to the institution’s board of directors to inform them of the change in the rating. The memo should explain the reasons for the change and any resulting consequences. The memorandum should also contain a definition of the new rating assigned and standard language prohibiting disclosure of the rating.

11. Enter the new rating(s) in the EDS ratings section and make certain they are correct.

12. Update the Regulatory Profile with any other appropriate information.

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Examiner's Summary, Recommendations, and Comments

Exam Date: ____________________
Prepared By: ____________________
Reviewed By: ____________________
Docket #: ____________________

UNIFORM FINANCIAL INSTITUTIONS[1] RATING SYSTEM

Introduction

The Uniform Financial Institutions Rating System (UFIRS) was adopted by the Federal Financial Institutions Examination Council (FFIEC) on November 13, 1979. Over the years, the UFIRS has proven to be an effective internal supervisory tool for evaluating the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special attention or concern. A number of changes, however, have occurred in the banking industry and in the Federal supervisory agencies' policies and procedures which have prompted a review and revision of the 1979 rating system. The revisions to UFIRS include the addition of a sixth component addressing sensitivity to market risks, the explicit reference to the quality of risk management processes in the management component, and the identification of risk elements within the composite and component rating descriptions.

The revisions to UFIRS are not intended to add to the regulatory burden of institutions or require additional policies or processes. The revisions are intended to promote and complement efficient examination processes. The revisions have been made to update the rating system, while retaining the basic framework of the original rating system.

The UFIRS takes into consideration certain financial, managerial, and compliance factors that are common to all institutions. Under this system, the supervisory agencies endeavor to ensure that all financial institutions are evaluated in a comprehensive and uniform manner, and that supervisory attention is appropriately focused on the financial institutions exhibiting financial and operational weaknesses or adverse trends.

The UFIRS also serves as a useful vehicle for identifying problem or deteriorating financial institutions, as well as for categorizing institutions with deficiencies in particular component areas. Further, the rating system assists Congress in following safety and soundness trends and in assessing the aggregate strength and soundness of the financial industry. As such, the UFIRS assists the agencies in fulfilling their collective mission of maintaining stability and public confidence in the nation's financial system.

Overview

Under the UFIRS, each financial institution is assigned a composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations. These component factors address the adequacy of capital, the quality of assets, the capability of management, the quality and level of earnings, the adequacy of liquidity, and the sensitivity to market risk. Evaluations of the components take into consideration the institution’s size and sophistication, the nature and complexity of its activities, and its risk profile.

Composite and component ratings are assigned based on a 1 to 5 numerical scale. A 1 indicates the highest rating, strongest performance and risk management practices, and least degree of supervisory concern, while

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[1] For purposes of this rating system, the term “financial institution” refers to those insured depository institutions whose primary Federal supervisory agency is represented on the Federal Financial Institutions Examination Council (FFIEC). The agencies comprising the FFIEC are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. The term “financial institution” includes Federally supervised commercial banks, savings and loan associations, mutual savings banks, and credit unions.

a 5 indicates the lowest rating, weakest performance, inadequate risk management practices and, therefore, the highest degree of supervisory concern.

The composite rating generally bears a close relationship to the component ratings assigned. However, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors comprising that component and its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the financial institution. Assigned composite and component ratings are disclosed to the institution's board of directors and senior management.

The ability of management to respond to changing circumstances and to address the risks that may arise from changing business conditions, or the initiation of new activities or products, is an important factor in evaluating a financial institution's overall risk profile and the level of supervisory attention warranted. For this reason, the management component is given special consideration when assigning a composite rating.

The ability of management to identify, measure, monitor, and control the risks of its operations is also taken into account when assigning each component rating. It is recognized, however, that appropriate management practices vary considerably among financial institutions, depending on their size, complexity, and risk profile. For less complex institutions engaged solely in traditional banking activities and whose directors and senior managers, in their respective roles, are actively involved in the oversight and management of day-to-day operations, relatively basic management systems and controls may be adequate. At more complex institutions, on the other hand, detailed and formal management systems and controls are needed to address their broader range of financial activities and to provide senior managers and directors, in their respective roles, with the information they need to monitor and direct day-to-day activities. All institutions are expected to properly manage their risks. For less complex institutions engaging in less sophisticated risk taking activities, detailed or highly formalized management systems and controls are not required to receive strong or satisfactory component or composite ratings.

Foreign Branch and specialty examination findings and the ratings assigned to those areas are taken into consideration, as appropriate, when assigning component and composite ratings under UFIRS. The specialty examination areas include: Compliance, Community Reinvestment, Government Security Dealers, Information Systems, Municipal Security Dealers, Transfer Agent, and Trust.

The following two sections contain the composite rating definitions, and the descriptions and definitions for the six component ratings.

COMPOSITE RATINGS

Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance. The six key components used to assess an institution's financial condition and operations are: capital adequacy, asset quality, management capability, earnings quantity and quality, the adequacy of liquidity, and sensitivity to market risk. The rating scale ranges from 1 to 5, with a rating of 1 indicating: the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile; and the level of least supervisory concern. A 5 rating indicates: the most critically deficient level of performance; inadequate risk management practices relative to the institution's size, complexity, and risk profile; and the greatest supervisory concern. The composite ratings are defined as follows:

Composite 1

Financial institutions in this group are sound in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the board of directors and management. These financial institutions are the most capable of withstanding the vagaries of business conditions and are resistant to outside influences such as economic instability in their trade area. These financial institutions are in substantial compliance with laws and regulations. As a result, these financial institutions exhibit the strongest performance and risk management practices relative to the institution’s size, complexity, and risk profile, and give no cause for supervisory concern.

Composite 2

Financial institutions in this group are fundamentally sound. For a financial institution to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the board of directors’ and management’s capabilities and willingness to correct. These financial institutions are stable and are capable of withstanding business fluctuations. These financial institutions are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution’s size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Composite 3

Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution’s size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

Composite 4

Financial institutions in this group generally exhibit unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the institution’s size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the deposit insurance fund. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

Composite 5

Financial institutions in this group exhibit extremely unsafe and unsound practices or conditions; exhibit a critically deficient performance; often contain inadequate risk management practices relative to the institution’s size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management’s ability or willingness to control or correct. Immediate outside financial or other assistance is needed in order for the financial institution to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the deposit insurance fund and failure is highly probable.

COMPONENT RATINGS

Each of the component rating descriptions is divided into three sections: an introductory paragraph; a list of the principal evaluation factors that relate to that component; and a brief description of each numerical rating for that component. Some of the evaluation factors are reiterated under one or more of the other components to reinforce the interrelationship between components. The listing of evaluation factors for each component rating is in no particular order of importance.

Capital Adequacy

A financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution’s financial condition should be considered when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution's activities will determine the extent to which it may be necessary to maintain capital at levels above required regulatory minimums to properly reflect the potentially adverse consequences that these risks may have on the institution's capital.

The capital adequacy of an institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of capital and the overall financial condition of the institution.
- The ability of management to address emerging needs for additional capital.
- The nature, trend, and volume of problem assets, and the adequacy of allowances for loan and lease losses and other valuation reserves.
- Balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities.
- Risk exposure represented by off-balance sheet activities.
- The quality and strength of earnings, and the reasonableness of dividends.
- Prospects and plans for growth, as well as past experience in managing growth.
- Access to capital markets and other sources of capital, including support provided by a parent holding company.

Ratings

1 A rating of 1 indicates a strong capital level relative to the institution's risk profile.

2 A rating of 2 indicates a satisfactory capital level relative to the financial institution's risk profile.

3 A rating of 3 indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements.

4 A rating of 4 indicates a deficient level of capital. In light of the institution's risk profile, viability of the institution may be threatened. Assistance from shareholders or other external sources of financial support may be required.

5 A rating of 5 indicates a critically deficient level of capital such that the institution's viability is threatened. Immediate assistance from shareholders or other external sources of financial support is required.

Asset Quality

The asset quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, and other assets, as well as off-balance sheet transactions. The ability of management to identify, measure, monitor, and control credit risk is also reflected here. The evaluation of asset quality should consider the adequacy of the allowance for loan and lease losses and weigh the exposure to counterparty, issuer, or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of an institution's assets, including, but not limited to, operating, market, reputation, strategic, or compliance risks, should also be considered.

The asset quality of a financial institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices.
- The level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance sheet transactions.
- The adequacy of the allowance for loan and lease losses and other asset valuation reserves.
- The credit risk arising from or reduced by off-balance sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit.
- The diversification and quality of the loan and investment portfolios.
- The extent of securities underwriting activities and exposure to counterparties in trading activities.
- The existence of asset concentrations.

- The adequacy of loan and investment policies, procedures, and practices.
- The ability of management to properly administer its assets, including the timely identification and collection of problem assets.
- The adequacy of internal controls and management information systems.
- The volume and nature of credit documentation exceptions.

Ratings

1 A rating of 1 indicates strong asset quality and credit administration practices. Identified weaknesses are minor in nature and risk exposure is modest in relation to capital protection and management's abilities. Asset quality in such institutions is of minimal supervisory concern.

2 A rating of 2 indicates satisfactory asset quality and credit administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities.

3 A rating of 3 is assigned when asset quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is generally a need to improve credit administration and risk management practices.

4 A rating of 4 is assigned to financial institutions with deficient asset quality or credit administration practices. The levels of risk and problem assets are significant, inadequately controlled, and subject the financial institution to potential losses that, if left unchecked, may threaten its viability.

5 A rating of 5 represents critically deficient asset quality or credit administration practices that present an imminent threat to the institution's viability.

Management

The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's activities, management practices may need to address some or all of the following risks: credit, market, operating or transaction, reputation, strategic, compliance, legal, liquidity, and other risks. Sound management practices are demonstrated by: active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls taking into consideration the size and sophistication of the institution; maintenance of an appropriate audit program and internal control environment; and effective risk monitoring and management information systems. This rating should reflect the board's and management’s ability as it applies to all aspects of banking operations as well as other financial service activities in which the institution is involved.

The capability and performance of management and the board of directors is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of oversight and support of all institution activities by the board of directors and management.
- The ability of the board of directors and management, in their respective roles, to plan for, and respond to, risks that may arise from changing business conditions or the initiation of new activities or products.
- The adequacy of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities.
- The accuracy, timeliness, and effectiveness of management information and risk monitoring systems appropriate for the institution’s size, complexity, and risk profile.
- The adequacy of audits and internal controls to: promote effective operations and reliable financial and regulatory reporting; safeguard assets; and ensure compliance with laws, regulations, and internal policies.
- Compliance with laws and regulations.
- Responsiveness to recommendations from auditors and supervisory authorities.
- Management depth and succession.
- The extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority.
- Reasonableness of compensation policies and avoidance of self-dealing.
- Demonstrated willingness to serve the legitimate banking needs of the community.
- The overall performance of the institution and its risk profile.

Ratings

1 A rating of 1 indicates strong performance by management and the board of directors and strong risk management practices relative to the institution’s size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

2 A rating of 2 indicates satisfactory management and board performance and risk management practices relative to the institution’s size, complexity, and risk profile. Minor weaknesses may exist, but are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

3 A rating of 3 indicates management and board performance that need improvement or risk management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

4 A rating of 4 indicates deficient management and board performance or risk management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.

5 A rating of 5 indicates critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

Earnings

This rating reflects not only the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings. The quantity as well as the quality of earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses and require additions to the allowance for loan and lease losses, or by high levels of market risk that may unduly expose an institution's earnings to volatility in interest rates. The quality of earnings may also be diminished by undue reliance on extraordinary gains, nonrecurring events, or favorable tax effects. Future earnings may be adversely affected by an inability to forecast or control funding and operating expenses, improperly executed or ill-advised business strategies, or poorly managed or uncontrolled exposure to other risks.

The rating of an institution's earnings is based upon, but not limited to, an assessment of the following evaluation factors:

- The level of earnings, including trends and stability.
- The ability to provide for adequate capital through retained earnings.
- The quality and sources of earnings.
- The level of expenses in relation to operations.
- The adequacy of the budgeting systems, forecasting processes, and management information systems in general.

- The adequacy of provisions to maintain the allowance for loan and lease losses and other valuation allowance accounts.

- The earnings exposure to market risk such as interest rate, foreign exchange, and price risks.

Ratings

1 A rating of 1 indicates earnings that are strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.

2 A rating of 2 indicates earnings that are satisfactory. Earnings are sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution’s level of earnings is adequate in view of the assessment factors listed above.

3 A rating of 3 indicates earnings that need to be improved. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.

4 A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. Institutions so rated may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.

5 A rating of 5 indicates earnings that are critically deficient. A financial institution with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.

Liquidity

In evaluating the adequacy of a financial institution’s liquidity position, consideration should be given to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds management practices relative to the institution’s size, complexity, and risk profile. In general, funds management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds management practices should ensure that liquidity is not maintained at a high cost, or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Liquidity is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The adequacy of liquidity sources compared to present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition.

- The availability of assets readily convertible to cash without undue loss.
- Access to money markets and other sources of funding.
- The level of diversification of funding sources, both on- and off-balance sheet.
- The degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer term assets.
- The trend and stability of deposits.
- The ability to securitize and sell certain pools of assets.
- The capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds management strategies, liquidity policies, management information systems, and contingency funding plans.

Ratings

1 A rating of 1 indicates strong liquidity levels and well-developed funds management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

2 A rating of 2 indicates satisfactory liquidity levels and funds management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds management practices.

3 A rating of 3 indicates liquidity levels or funds management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds management practices.

4 A rating of 4 indicates deficient liquidity levels or inadequate funds management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.

5 A rating of 5 indicates liquidity levels or funds management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

Sensitivity to Market Risk

The sensitivity to market risk component reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital. When evaluating this component, consideration should be given to: management's ability to identify, measure, monitor, and control market risk; the institution's size; the nature and complexity of its activities; and the adequacy of its capital and earnings in relation to its level of market risk exposure.
For many institutions, the primary source of market risk arises from nontrading positions and their sensitivity to changes in interest rates. In some larger institutions, foreign operations can be a significant

source of market risk. For some institutions, trading activities are a major source of market risk.

Market risk is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign exchanges rates, commodity prices, or equity prices.
- The ability of management to identify, measure, monitor, and control exposure to market risk given the institution's size, complexity, and risk profile.
- The nature and complexity of interest-rate risk exposure arising from nontrading positions.
- Where appropriate, the nature and complexity of market risk exposure arising from trading and foreign operations.

Ratings

1 A rating of 1 indicates that market risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of market risk taken by the institution.

2 A rating of 2 indicates that market risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk management practices are satisfactory for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of market risk taken by the institution.

3 A rating of 3 indicates that control of market risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk management practices need to be improved given the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital may not adequately support the degree of market risk taken by the institution.

4 A rating of 4 indicates that control of market risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk management practices are deficient for the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of market risk taken by the institution.

5 A rating of 5 indicates that control of market risk sensitivity is unacceptable or that the level of market risk taken by the institution is an imminent threat to its viability. Risk management practices are wholly inadequate for the size, sophistication, and level of market risk accepted by the institution.

OFFICE OF THE COMPTROLLER OF THE CURRENCY
OFFICE OF THRIFT SUPERVISION
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
FEDERAL DEPOSIT INSURANCE CORPORATION

March 4, 1997

JOINT INTERAGENCY COMMON QUESTIONS AND ANSWERS ON THE REVISED UNIFORM FINANCIAL INSTITUTIONS RATING SYSTEM

On March 4, 1997, the Task Force on Supervision of the Federal Financial Institutions Examination Council approved the issuance of common questions and answers about the recently revised Uniform Financial Institutions Rating System. The Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Reserve Board (FRB), and the Federal Deposit Insurance Corporation (FDIC) collectively developed common responses to questions asked to date by bankers and examiners regarding the revised rating system. The responses were coordinated with the Conference of State Bank Supervisors. The purpose of the questions and answers is to provide additional interagency guidance and clarification regarding the revised rating system.

On December 9, 1996, the Federal Financial Institutions Examination Council (FFIEC) adopted the revised Uniform Financial Institutions Rating System (UFIRS or CAMELS rating system). The UFIRS is an internal rating system used by the federal and state regulators for assessing the soundness of financial institutions on a uniform basis and for identifying those insured institutions requiring special supervisory attention. A final notice was published in the *Federal Register* on December 19, 1996 (61 FR 67021), effective January 1, 1997.

The major changes to UFIRS include an increased emphasis on the quality of risk management practices and the addition of a sixth component called “Sensitivity to Market Risk.” The updated rating system also reformats and clarifies component rating descriptions and component rating definitions, revises composite rating definitions to parallel the other changes in the rating system, and highlights risks that may be considered in assigning component ratings.

The attached questions and answers are being distributed to bankers and examiners to ensure consistent and uniform implementation of the revised rating system.

COMMON QUESTIONS AND ANSWERS ON THE REVISED UNIFORM FINANCIAL INSTITUTIONS RATING SYSTEM

(1) How will the new Sensitivity to Market Risk (S) component rating be determined?

The rating assigned to the S component should reflect a combined assessment of **both** the level of market risk and the ability to manage market risk. Low market risk sensitivity alone may not be sufficient to achieve a favorable S rating. Indeed, institutions with low risk, but inadequate market risk management, may be subject to unfavorable S ratings. Conversely, institutions with moderate levels of market risk and the demonstrated ability to ensure that market risk is, and will remain, well controlled may receive favorable S component ratings.

In assessing the level of market risk exposure and the risk management process in place to control it, examiners will rely on existing supervisory guidance issued by their respective agencies, including guidance issued on interest-rate risk, investment, financial derivatives, and trading activities.

(2) Will institutions be expected to have formal, sophisticated risk management processes in order to receive the favorable ratings for S?

In line with the general thrust of the agencies' various guidance on market risk, the sophistication of an institution's risk management system is expected to be commensurate with the complexity of its holdings and activities and appropriate to its specific needs and circumstances. Institutions with relatively noncomplex holdings and activities, and whose senior managers are actively involved in the details of daily operations, may be able to rely on relatively basic and less formal risk management systems. If the procedures for managing and controlling market risks are adequate, communicated clearly, and well understood by all relevant parties, these basic processes may, when combined with low to moderate levels of exposure, be sufficient to receive a favorable rating for the S component.

Organizations with more complex holdings, activities and business structures may require more elaborate and formal market risk management processes in order to receive ratings of 1 or 2 for the S component.

(3) How much weight should be placed on the S component in determining the composite rating?

The weight attributed to any individual component in determining the composite rating should vary depending on the degree of supervisory concern associated with the component. The composite rating does not assume a predetermined weight for each component and it does not represent an arithmetic average of assigned component ratings. As a result, for most institutions where market risk is not a significant issue, less weight should be placed on the S component in determining a composite rating than on other components.

(4) How should the S rating be applied when evaluating small community banks or thrifts with limited asset/liability management processes?

For most small community banks or thrifts, sensitivity to market risk will primarily reflect interest-rate risk. Regardless of the size of an institution, the quality of risk management systems must be commensurate with the nature and complexity of its risk-taking activities, and management's ability to identify, measure, monitor and control the risk. Evaluation of this component will be based on the degree to which interest-rate risk exposure can affect the institution's earnings and capital, and the effectiveness of the institution's asset/liability or interest-rate risk management system, given its particular situation.

(5) If the levels of market risk change between examinations, is it always necessary to change the rating assigned to the S component?

The rating assigned to the S component should reflect a combined assessment of both the level of market risk and the ability to manage market risk. Accordingly, changes in either quantitative or qualitative aspects of market risk exposure or management may necessitate changes in the rating assigned to the S component. While changes in the level of market risk between examinations may in some circumstances necessitate a change in the rating assigned to the S component, this does not automatically imply a rating change. For example, an institution that accepts additional market risk between examinations, but maintains risk management processes and earnings and capital levels commensurate with the level of risk, need not have its S rating changed.

(6) Does the increased emphasis on market risk management practices place new and burdensome requirements on institutions or examiners?

The updated rating system incorporates examination considerations that were not explicitly noted in the prior rating system. Under the prior rating system, examiners considered market risk exposure and risk management practices when assigning component and composite ratings. Consequently, examiners are not required to perform any additional procedures, and institutions are not required to add to their management procedures or practices, solely because of the updated rating system.

(7) Will the revised rating system, with the addition of the new Sensitivity to Market Risk (S) component and increased emphasis on the quality of risk management practices, result in a change in a bank's or thrift's composite rating?

The revised rating system generally should not result in a change in the composite rating assigned to a particular bank or thrift simply because of the addition of the new component and the increased emphasis on risk management practices. The level of market risk has traditionally been taken into consideration when evaluating an institution's capital, earnings and liquidity. The quality of an institution's risk management practices has also traditionally been considered by examiners when assessing an institution's condition and assigning ratings, particularly in the Management component.

(8) How much weight should be given to risk management practices versus the level of exposure, as measured by specific ratios, when assigning a component rating?

The CAMELS rating system assesses an institution's overall condition based on both quantitative and qualitative elements. Quantitative data such as the level of classified assets remain an integral part of that measurement. Qualitative elements, such as the adequacy of board and senior management oversight, policies, risk management practices, and management information systems are also central to the evaluation of components. The relative importance given to the qualitative considerations for each component depends on the circumstances particular to the institution. Risk management systems should be appropriate for the nature and level of risks the institution assumes. However, unacceptable risk levels or an unsatisfactory financial condition will often outweigh other factors and result in an adverse component rating.

(9) Why aren't peer data comparisons specifically mentioned in the revised rating system? May they still be used in assigning ratings?

Peer data are an integral part of the evaluation process and, when available and relevant, may be used in assigning a rating. However, peer data should be used in conjunction with other pertinent evaluation factors and not relied upon in isolation when assigning a rating.

(10) Agency guidelines require examiners to discuss with senior management and, when appropriate, with the board of directors the evaluation factors they considered in assigning component ratings and a composite rating. Are examiners limited to only those evaluation factors listed in the revised rating system and must each evaluation factor be addressed when assessing a component area?

No. Examiners have the flexibility to consider any other evaluation factors that, in their judgment, relate to the component area under review. The evaluation factors listed under a component area are not intended to be all-inclusive, but rather a list of the more common factors considered under that component. Only those factors believed relevant to fully support the rating being assigned by the examiner need be addressed in the report and in discussions with senior management.

(11) With multiple references to some items across several components, such as market risk and management's ability to identify, measure, monitor, and control risk, are we "double counting" these and other items when assigning a rating?

Each component is interrelated with one or more other components. For example, the level of problem assets in an institution is a primary consideration in assigning an asset quality component rating. But it is also an item that affects the capital and earnings component ratings. The level of market risk and the quality of risk management practices are elements that also can affect several components. Examiners consider relevant factors and their interrelationship among components when assigning ratings.

(12) To what extent should market risk be carved out of the earnings or capital evaluation? Should institutions with high market risk receive an adverse rating in the earnings or capital components as well as the market sensitivity component?

Market risk is evaluated primarily under the new S component and is only one of several evaluation factors used to assess the earnings and capital components. Whether the institution's exposure to market risk results in an unfavorable rating for earnings or capital, however, is based on a careful analysis of the effect of this factor in relation to the other factors considered under these components. The capital component is evaluated based on the risk profile of an institution, including the effect of market risk, and whether the level of capital supports those risks. The earnings component evaluates the ability of earnings to support operations and maintain adequate capital after considering factors, such as market risk exposure, that affect the quantity, quality, and trend of earnings. The importance accorded to an evaluation factor should thus depend on the situation at the institution.