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.