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The Risk Management Examination and Your Community Bank

FDIC 

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The Risk Management Examination and Your Community Bank

The on-site examination is perhaps the single most important point of contact between the FDIC and the banks it supervises. Regardless of whether an examination results in a satisfactory evaluation as is generally the case, or in a recommendation for a corrective program, our experience has been that the cultivation of open lines of communication before, during, and after an examination can make for a more effective and satisfactory process for all concerned. In that spirit, the purpose of this article is to provide an overview of the examination process and call attention to the FDIC's commitment to enhance communication with community banks and help them better navigate their examinations.

The FDIC's Community Bank Initiative and Other Outreach

The FDIC has developed a series of community bank initiatives for 2012 to further our dialogue and better understand the challenges and opportunities facing these important institutions. These initiatives include a national conference earlier this year that focused on the future of community banks and their unique role in supporting our economy; a series of round-table discussions between FDIC officials and community bankers in each of the FDIC's six regions; and a major research initiative to examine key issues related to community banks, including their evolution, characteristics, performance, and role in local communities. In addition, as part

of this initiative, the FDIC is reviewing its examination and rulemaking processes to see if we can identify ways to improve our processes and communications while maintaining our supervisory standards. The FDIC will continue to use an array of outreach tools to communicate with community banks, including Directors College programs, participation at industry-sponsored events, and publications such as this one, where the industry can learn about emerging banking trends and gain a better understanding of the supervisory process.

Effective Communication throughout a Bank Examination

Financial performance ratios and other quantitative measures are only part of the comprehensive process that supervisors use to evaluate an institution's overall condition. Bank examinations rely on an assessment of both qualitative factors and quantitative measures of financial performance and condition to determine examination ratings and document conclusions. Although making these determinations is ultimately the FDIC's responsibility, a constructive dialogue between examiners and bankers can enhance the FDIC's understanding of an institution's policies, business strategies, risk management programs, and financial position. The FDIC pursues many avenues to foster a dialogue with community banks including pre-examination discussions with senior bank management, invitations to directors to meet with examination personnel during on-site reviews, telephone contacts between examinations, and various outreach events at national and state levels.

Bankers often tell us that maintaining communications with supervisory staff helps them understand the FDIC's expectations and can be a useful source of information about supervisory and regulatory matters. Some community banks find it extremely helpful to develop productive working relationships with their field supervisors (FSs) and assistant regional directors (ARDs). These FDIC managers lead our operational role in examinations, application reviews, and other requests. By establishing a working relationship with these individuals as well as state banking department personnel, bankers

Benefits of Open Communication with the Regulators

- Allows banks to better monitor the progress of an examination, ask questions, or request clarification to ensure that supervisory findings are well understood.
- Ensures examiners understand the bank's perspective on important supervisory matters.
- Minimizes the likelihood of surprises at the conclusion of a bank examination or supervisory determination for regulatory applications.
- Enables banks to benefit from supervisors' expertise on FDIC regulations and policies, emerging risks, banking product innovations, and the deployment of technology.

It is the Examiner-in-Charge's (EIC's) responsibility to keep management apprised of examination progress and findings, but bankers should not hesitate to proactively request or initiate additional opportunities for communication.

can use the regulators as a resource and gain insight into regulatory expectations and procedures.

The examination process and opportunities for enhancing communication are explained below.

Before an Examination

Pre-examination planning is designed to ensure that banks' and examiners' time and resources are used effectively and can sometimes reduce the length of the on-site examination. Banks are informed of an upcoming risk management examination by telephone call or letter. At this time, the bank likely receives preliminary requests for information that will be used to scope the review. The EIC or other staff member from the local field office typically contacts the institution 45 days before the commencement of an examination to begin planning discussions with the chief executive officer (CEO) or other designated members of management. CEOs should use this opportunity to discuss the scope and timeline of the

An example of effective communication *immediately before an examination*

Several weeks before an examination began, bank management contacted the EIC to advise him of certain irregularities related to the recent resignation of a bank officer. The EIC met with bank management one week before the examination team arrived to assess the impact of these irregularities. These early discussions allowed the EIC to complete his review of the situation, resulting in a more narrowly scoped, risk-focused examination.

review with the EIC to understand the focus of the examination.

Management is then provided with an examination request list, which outlines the data, reports, documents, and policy manuals that examiners need to initiate their work. Banks usually provide information for the examination request list through *FDICconnect*. If a bank's risk management programs and monitoring tools extend beyond the materials requested by the EIC, CEOs should share this information with the EIC during the pre-examination process to ensure all aspects of the bank's risk management program are appropriately considered. It is the EIC's responsibility to use this requested material as effectively and efficiently as possible, which can result in significant progress on examination activities before the on-site review begins.

In advance of the examination, the EIC will discuss with bank management financial performance trends, recent significant transactions, and future plans; these discussions will enable the EIC to adjust the examination scope and develop an efficient, risk-focused examination plan. Pre-examination discussions allow the CEO or other members of management to brief the EIC on the bank's organizational structure, business lines, market conditions, risk management processes, and strategic plans. Before the examination begins, the CEO and EIC should schedule several meetings during the on-site review to discuss the examination's progress and preliminary findings.

During an Examination

The scope of the examination will depend in part on the bank's specific exposures and unique risks. For example, institutions with credit concentrations or new product lines should expect a certain level of examiner review of those areas. Examiners also will follow-up on prior regulatory recommendations and review the bank's efforts to ensure compliance with new laws and regulations.

Dialogue between the CEO and the EIC during the examination is intended to help bank management understand the

What can bankers expect from an FDIC examination?

FDIC supervisory staff commits to:

- Explaining the anticipated timeline and the scope of the review.
- Conducting an orderly examination and making every effort to avoid disruptions or duplicate information requests.
- Conducting business professionally and respectfully.
- Clarifying regulatory expectations and explaining examination findings in plain English.
- Meeting with bank management (or board members, as requested) during the examination to provide updates on examination progress and findings.
- Listening to and considering the bank's concerns about examination conclusions and providing sufficient opportunity for feedback and clarification before the examination is completed.

preliminary findings and keep management current on the progress of the examination. These conversations present opportunities for bankers to ask questions, provide additional information, or request clarification. Bankers sometimes find such meetings to be a useful source of information about FDIC regulations and policies. Apart from the specific findings of an examination, some bankers report that they have benefited from examiners' informal observations, based on experience in numerous community bank examinations, about matters such as risk management processes, banking product innovations, internal controls, and the use of technology.

At the conclusion of the on-site examination, the EIC will schedule an exit meeting with senior management to ensure bank management has a clear understanding of the findings and proposed ratings. During this meeting, the EIC will explain the FDIC's conclusions and recommendations, confirm management's responses and commitments, and discuss preliminary assigned ratings and content of the written Report of Examination. Bank management should use this exit meeting to affirm commitments to examination recommendations and discuss any concerns with the examination conclusions.

An example of effective communication during an examination

During the examination, the EIC expressed concern about the structure of a bank's internal audit department. Management believed that contracting with an outside firm might resolve the concern, but first discussed its options with the EIC. The EIC explained existing regulatory guidance on audit structure and, following this discussion, management instead decided to expand the existing internal audit staff. This approach improved audit coverage and, going forward, enhanced the flexibility of the internal audit program.

Following the Examination

Following the on-site review, the EIC generally will arrange a meeting with the institution's board of directors. For risk management examinations, the EIC, along with the field office management or a regional office representative, will participate in a meeting with the directorate or a significant board committee. The board meeting is intended to inform the directorate of examination findings, affirm management's commitments to address key weaknesses or recommendations, and provide board members with an opportunity to talk with FDIC staff. The EIC generally focuses his or her presentation on matters requiring the board's attention, substantive findings and recommendations, proposed ratings, and expected follow-up actions by the bank. The EIC will encourage board members to participate in the discussion, as the FDIC strongly believes board leadership is critical to the success of the banking organization. Finally, field office management or the regional office staff member

will place examination findings in context with industry trends and share insights on new regulatory initiatives.

Before finalization, the Report of Examination undergoes a quality control review by the field or regional office to ensure the content is accurate, the findings are consistent with FDIC policies, and the tone is appropriate given the institution's overall condition. Once these reviews are completed, the Report of Examination is transmitted to the bank's board of directors. The board should review the Report¹ in its entirety, discuss the findings and recommendations during the next meeting, and monitor management's action plan for addressing any cited weaknesses or recommendations. If requested in the transmittal letter accompanying the Report of Examination, a written response to the examination should be prepared, ratified by the directorate, and submitted to the FDIC and state authority within the requested timeframe. If a formal or informal corrective program is proposed, senior management and board members are encouraged to meet with the FDIC regional office and state officials to discuss the provisions of the program and voice any questions or concerns. This discussion often occurs at a board meeting.

¹ 12 CFR § 309.6 <http://www.fdic.gov/regulations/laws/rules/2000-3800.html>.

Tips for Navigating the Examination Process

Before an Examination

- Meet with the EIC and brief him or her on the bank's strategy, performance, key exposures, and risk management efforts.
- Fulfill the examination information request list and, if necessary, ask for clarification if requested items do not appear to be applicable to the institution.

During an Examination

- Schedule progress meetings with the EIC.
- Discuss any concerns with examiner findings early in the process.

Following the Examination

- Provide a written response to the examination with follow-up actions that appropriately address supervisory recommendations.
- Schedule a meeting with the FDIC if the final Report of Examination raises questions.

Expressing Concerns about Examination Findings

Banks should expect our examination findings to be fair, fact-based, and consistent with FDIC policies and procedures. The FDIC prefers to have an ongoing dialogue during examinations to discuss preliminary findings and allow management to respond. Although there may be cases when regulators and bankers “agree to disagree,” the FDIC wants to ensure our position considers all perspectives. At the bank's discretion, concerns about examination findings can be raised to the FS or

ARD. The bank also may present issues or concerns to our regional executives, including the regional director and deputy regional director, as these individuals are actively involved in working through significant matters with institutions as they arise. If these informal channels do not resolve an institution's concerns with supervisory findings, the institution has a range of appeal options detailed in the March 1, 2011 Financial Institution Letter titled *Reminder on FDIC Examination Findings*.²

Other Communications with Banking Supervisors

Between regular community bank examinations, the FDIC uses off-site monitoring and on-site visitations as part of our risk monitoring program. Our interim activities may include telephone calls or other contacts with the CEO to follow-up on examination findings, unanticipated external events, consumer complaints, or significant changes in data reported in the Consolidated Reports of Condition and Income. These contacts are a normal part of our supervisory process and allow bankers to ask questions, request clarification, or discuss steps taken to address examination findings.

Another possible and significant contact between examinations occurs when a bank seeks regulatory approval via an application to engage in certain transactions and activities, including branching, mergers and acquisitions, investments in real estate,

² FIL-13-2011, *Reminder on FDIC Examination Findings*, March 1, 2011, <http://www.fdic.gov/news/news/financial/2011/fil11013a.html>.

What are bankers' options if they have concerns with the examination process or related requests?

- Bank management should discuss concerns with the EIC.
- If this discussion does not satisfactorily address the matter, bank management should contact the EIC's supervisor (the Field Supervisor).
- If those efforts are unsuccessful in resolving issues, we encourage banks to contact the appropriate FDIC regional office.
- Should discussions with regional office personnel not resolve bank management's concerns, the bank may informally or formally appeal examination findings.
- Alternatively, the bank can contact the FDIC Office of the Ombudsman at 877-ASK-FDIC (Option 3) or Ombudsman@fdic.gov.

*FDIC staff is **strictly prohibited** from retaliating over disagreements or complaints.*

capital retirement, and changes in control. When planning to submit an application, bankers should feel free to contact the FDIC regional office to discuss the request, the required content of the application, and the anticipated processing timeline. Bankers may find it helpful to meet with regional office staff and state officials to walk through more complex proposals and gain insights into legal requirements. Our regional office staff is available to answer questions and provide an update on the application's status.

As with examinations, if an institution is dissatisfied with the processing of the application, bank management should

voice those concerns to the application reviewer or ARD to better understand the FDIC's procedures, information needs, and expected timeline. Once a determination on the application is reached, the institution is notified in writing. If the bank's application is denied, in certain cases the bank may seek an appeal as described in the FDIC's *Appeals of Material Supervisory Determinations – Guidelines and Decisions*.³

Conclusion

The FDIC continues to explore ways to strengthen its working relationships with the banking industry and individual community banks. Bankers are encouraged to contact field supervisors and regional office staff with questions or concerns regarding the regulatory process or recent developments at their institutions. FDIC supervisors are available to share insights, offer perspectives, and direct bank management to resources that may help resolve issues or concerns. Bankers also are encouraged to send suggestions to the FDIC's Community Banking mailbox at CommunityBanking@fdic.gov.

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³ FDIC. *Appeals of Material Supervisory Determinations – Guidelines and Decisions*, April 13, 2010, <http://www.fdic.gov/regulations/laws/sarc/>.

