



## Offsite Reviews of 1- and 2-Rated Institutions

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December 2019

Eval-20-002

### Evaluation Report Program Audits and Evaluations

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## Executive Summary

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### Offsite Reviews of 1- and 2-Rated Institutions

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Section 10(d) of the Federal Deposit Insurance Act requires onsite examinations of every FDIC-insured financial institution at least once during each 12-month period (with certain exceptions for institutions that are well-managed and well-capitalized). However, between onsite examinations, an institution's financial condition may change. Therefore, the FDIC designed the Offsite Review Program to identify emerging supervisory concerns and potential problems between onsite examinations so that supervisory strategies could be adjusted appropriately.

Offsite reviews are performed quarterly for each bank that appears on the Offsite Review List (ORL), is added by a Regional Office, and/or is included on the Supplemental Review List (SRL). The ORL is generated from offsite monitoring financial models that identify 1- and 2-rated institutions whose quarterly Reports of Condition and Income indicate potential emerging supervisory concerns. Regional Offices may also add institutions that are not initially identified on the ORL for offsite review based on specific risks or concerns in their Regions. Finally, the Division of Risk Management Supervision (RMS) compiles the SRL based on RMS-determined criteria for risk outliers.

The objectives of our evaluation were to assess whether (1) the Offsite Review Program identified 1- and 2-rated institutions with emerging supervisory concerns; (2) the Offsite Review Program resulted in the FDIC appropriately adjusting the supervisory strategies for these institutions in a timely manner; and (3) the adjusted supervisory strategies were effective.

### Results

The Offsite Review Program identified 1- and 2-rated institutions with emerging supervisory concerns related to rapid growth, noncore funding, deteriorating financial trends, or those identified and added by the Regional Offices. However, the FDIC should:

- Evaluate additional methods and new technologies to identify institutions with other types of emerging supervisory concerns;
- Enhance the Offsite Review Procedures to provide detailed guidance for Case Managers regarding the offsite review process; and

- Provide Case Managers with training to ensure consistent application of offsite review procedures.

The FDIC should evaluate whether innovative technologies would provide predictive information on whether financial institutions have other types of emerging supervisory concerns. These could include concerns related to internal controls, credit administration, and management practices.

We found that offsite reviews were inconsistent in terms of the amount of time Case Managers spent, as well as the depth and coverage of Case Managers' review, due to a lack of guidance regarding the scope and methodology for conducting offsite reviews. In addition, conflicting perspectives existed between Case Managers and RMS senior managers on the importance of conducting offsite reviews of institutions that recur on the ORL.

The FDIC should enhance offsite review procedures and ensure that Case Managers receive training to ensure consistent application of offsite review procedures. Further, the FDIC should provide training to ensure Case Managers understand the importance of conducting offsite reviews of institutions that recur on the ORL. In addition, we noted that Case Managers incorrectly coded 52 of the 112 (46 percent) offsite reviews conducted based on the ORL and added by a Regional Office from the end of 2014 through 2017. These coding errors resulted in inaccurate management reports that overstated the adjusted onsite supervision that occurred as a result of the Offsite Review Program by 46 percent. We did not recommend training to address these errors, as the FDIC provided training on the proper use of codes after these errors had occurred.

When an emerging supervisory concern was identified for 1- and 2-rated institutions, we found that the FDIC appropriately adjusted its supervisory strategy in a timely manner; and the adjusted supervisory strategies were effective.

## Recommendations

Our report contains three recommendations to improve the FDIC's Offsite Review Program. Management concurred with the three recommendations. The recommendations will remain open until the OIG confirms that corrective actions have been completed and are responsive.



# Contents

<b>Background</b> .....	<b>2</b>
<b>Evaluation Results</b> .....	<b>7</b>
<b>The FDIC Should Evaluate Additional Methods to Identify 1- or 2-Rated Institutions with Other Types of Emerging Supervisory Concerns</b> .....	<b>7</b>
<b>The FDIC Should Enhance Procedures to Improve the Offsite Review Process</b> .....	<b>10</b>
<b>The FDIC Should Provide Offsite Review Training</b> .....	<b>12</b>
<b>The FDIC Adjusted Supervisory Strategies in a Timely Manner and the Adjusted Supervisory Strategies Were Effective</b> .....	<b>15</b>
<b>FDIC Comments and OIG Evaluation</b> .....	<b>16</b>
<b>Appendices</b>	
1. Objectives, Scope, and Methodology	17
2. Offsite Review Coding Instructions	20
3. FDIC Offsite Supervisory Programs	22
4. Number of Quarters Institutions Received Offsite Review	23
5. FDIC Comments	24
6. Summary of the FDIC’s Corrective Actions	25
<b>Table</b>	
1. Offsite Review Timelines	6
2. Factors Contributing to Downgrades of 150 IDIs Not Identified by the Offsite Review Program from December 31, 2014 through December 31, 2017	9
<b>Figures</b>	
1. ORL and Region-Added Offsite Reviews Conducted as of Quarters Ended December 31, 2014 through December 31, 2017	8
2. Institutions Requiring Offsite Review 7 or More Quarters Based on the ORL	13
3. Offsite Reviews Conducted on Institutions 7 or More Quarters Based on the ORL	13



December 18, 2019

**Subject | *Offsite Reviews of 1- and 2-Rated Institutions***

Section 10(d) of the Federal Deposit Insurance Act requires onsite examinations of every FDIC-insured financial institution at least once during each 12-month period. If an institution has assets totaling less than \$3 billion and is well-managed and well-capitalized, the examination interval may be extended to 18 months. Between onsite examinations, an institution's financial condition may change.

The FDIC's Division of Risk Management Supervision (RMS) designed the Offsite Review Program to identify emerging supervisory concerns that may occur at insured depository institutions (IDI) between onsite examinations so that supervisory strategies can be adjusted appropriately. In this way, the FDIC may take timely corrective action by adjusting its supervisory strategies, such as visitations<sup>1</sup> or expedited onsite examinations<sup>2</sup> of financial institutions.

The objectives of our evaluation were to assess whether (1) the Offsite Review Program identified 1- and 2-rated institutions with emerging supervisory concerns; (2) the Offsite Review Program resulted in the FDIC appropriately adjusting the supervisory strategies for these institutions in a timely manner; and (3) the adjusted supervisory strategies were effective.

We assessed offsite review statistics, trends, and results covering all six RMS Regional Offices for the period December 31, 2014 through December 31, 2017. We interviewed Case Managers and other RMS Officials at each of the Regional Offices. We conducted this evaluation in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation*. We conducted fieldwork from May 2018 through January 2019 at the FDIC's Headquarters locations in Washington, D.C. and Arlington, Virginia; and Regional Offices located in Chicago, Illinois; Dallas, Texas; and San Francisco, California. [Appendix 1](#) of this report includes additional details on our objectives, scope, and methodology. [Appendix 2](#) contains a description of Offsite Review Coding Instructions. [Appendix 3](#) provides a description of additional FDIC offsite

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<sup>1</sup> The term, "visitation," may be defined as any review that does not meet the minimum requirements of a full-scope examination. Examiners may conduct the reviews for a variety of reasons, such as to assess changes in an institution's risk profile or to monitor compliance with corrective actions.

<sup>2</sup> The minimum requirements of a full-scope examination are defined as the procedures necessary to complete the mandatory pages of the Uniform Report of Examination and evaluate all components of the Uniform Financial Institutions Rating System (UFIRS).

supervisory programs. [Appendix 4](#) provides the number of times institutions recurred on the ORL from December 31, 2014 through December 31, 2017.

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## BACKGROUND

According to the FDIC's *RMS Manual of Examination Policies*, "onsite examinations help ensure the stability of IDIs by identifying undue risks and weak risk management practices." IDIs are rated in accordance with the Uniform Financial Institutions Rating System (UFIRS). Pursuant to UFIRS, six areas of performance are evaluated and given a numerical CAMELS<sup>3</sup> rating (rating) of "1" through "5" with "1" representing the least degree of supervisory concern and "5" representing the greatest degree of supervisory concern. However, between examinations, an institution's financial condition may change and therefore a change to the rating may be appropriate. The Offsite Review Program is designed to identify emerging supervisory concerns and potential problems between onsite examinations so that supervisory strategies can be adjusted appropriately.

The Offsite Review Program includes both FDIC-supervised IDIs and those whose primary federal regulator (PFR)<sup>4</sup> is the Federal Reserve Board or the Office of the Comptroller of the Currency. Offsite reviews are conducted quarterly by Case Managers on institutions appearing on the Offsite Review List (ORL), added by a Regional Office, and/or included on the Supplemental Review List (SRL). Based on the results of the offsite review, RMS Regional Offices may adjust the FDIC's supervisory strategy for an IDI by expediting the examination schedule, conducting a visitation, or in the case of a non-FDIC-supervised institution, participating in the next examination of the other PFR.

### **The Offsite Review List and Institutions Added by a Regional Office**

The ORL is a component of the Offsite Review Program that is comprised of only 1- and 2-rated institutions. It is developed quarterly based on three models that analyze Consolidated Reports of Condition and Income, known as Call Reports,<sup>5</sup> over a 1- to 3-year time horizon in order to generate predictive scores. The

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<sup>3</sup> The six performance areas identified by the CAMELS acronym are **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk.

<sup>4</sup> The PFR is the federal regulatory agency that is the primary supervising entity of a financial institution. In most cases, this is the same agency that issued the initial charter allowing the financial institution to operate. Banks and other financial institutions must file quarterly Call Reports that indicate their income and overall condition to their primary regulatory authority.

<sup>5</sup> Call Reports are sworn statements of a bank's financial condition that banks submit to financial institution regulators quarterly in accordance with federal regulatory requirements. Call Reports consist of a balance sheet and income statement and provide financial ratios and data.

predictive scores are used to identify institutions with an increased likelihood of a downgrade at the next examination. These three models include:

- Statistical CAMELS Offsite Rating (SCOR). SCOR is designed to identify institutions that have experienced financial deterioration that is historically related to rating downgrades. SCOR is a statistical model used to predict ratings over a 1-year horizon using financial information from quarterly Call Report data.
- SCOR-Lag. SCOR-Lag is similar in design to SCOR, but adjusts financial ratios to account for rapidly growing banks.
- Growth Monitoring System (GMS). GMS is a model that uses Call Report data to identify institutions at risk of downgrade over a 3-year horizon based on rapid growth and/or a funding structure highly dependent on non-core funding sources.<sup>6</sup>

SCOR and SCOR-Lag identify 1- or 2-rated institutions that have a 50 percent (or higher) probability<sup>7</sup> of being downgraded to a rating of 3 or worse over a 1-year horizon. GMS identifies 1- or 2-rated institutions that are in the 98<sup>th</sup> or higher percentile of risk of downgrade over a 3-year horizon.

In addition to the ORL, which is based on the predictive models, Regional Offices<sup>8</sup> may also add institutions that are not initially identified on the ORL (Region-Added). This permits institutions to receive an offsite review based on concerns more specific to the Region. For example, during our evaluation, the Dallas Regional Office added institutions with an exposure to the oil and gas industry.

### Other Offsite Review Program Measures

In addition to the predictive models used to create the ORL, four other measures are available to Case Managers and the Regional Office to identify emerging risks. Regional Offices may use these measures as a source for adding institutions for review. Additionally, Case Managers may refer to the measures to evaluate whether additional concerns exist within the institution when conducting an offsite review. These measures include:

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<sup>6</sup> Noncore funding sources include brokered deposits, Federal Home Loan Bank Advances, Certificates of Deposit in excess of \$100,000, and other funding sources sensitive to interest rate volatility.

<sup>7</sup> RMS may adjust this percentage based on the financial condition of the banking industry to manage the number of institutions on the ORL.

<sup>8</sup> Regional Office officials stated that institutions are usually added by the Regional Risk Committee or Regional Director based on a variety of economic concerns.

- Real Estate Stress Test (REST). A model projecting an institution's rating subject to a real estate crisis similar to that in New England in the early 1990s.
- Consistent Grower. A tool that uses 20 quarters of GMS cumulative growth scores to identify rapidly growing institutions.
- Internal Control Assessment Rating System (ICARuS). ICARuS is a tool that identifies 11 common management and financial characteristics and 3 additional trend analysis indicators associated with financial institutions that may be more susceptible to fraud.
- Young Institutions. A tool identifying institutions that are less than 8 years old.

### Supplemental Review List

The Offsite Review Program also includes a Supplemental Review List (SRL). The SRL allows for new or emerging risks to be included in the quarterly offsite process. The criteria used to create the SRL may change over time based on economic trends observed in the banking industry. During the scope of our review, the SRL was compiled based on the following three additional offsite monitoring programs used to identify potential risks:

- Interest Rate Risk Outlier (IRR). This program uses a tool that simulates the financial impact of a hypothetical, immediate increase in interest rates and its effect on earnings and capital. The purpose of the IRR monitoring program is to identify, monitor, and better supervise certain institutions that may not be sufficiently prepared or positioned for sustained increases or volatility in interest rates.
- Liquidity Risk Monitoring. This program uses a tool to identify institutions with potentially high-risk liquidity characteristics based on Call Report data, supervisory examination information, and market data. The Liquidity Risk Monitoring program is designed to provide early identification of institutions that exhibit high-risk liquidity characteristics and to develop strategies to proactively address these risks.
- One Quarter Asset Growth Monitoring. This program identifies institutions experiencing significant one quarter growth in total assets. Banks with one quarter asset growth exceeding 15 percent are identified for review.

### Case Managers

Case Managers located in each of the FDIC's six Regional Offices<sup>9</sup> conduct offsite reviews. The primary responsibilities of Case Managers involve assessing risk to the Deposit Insurance Fund and directing the appropriate supervisory efforts to eliminate or manage such risk. Section 13 of the FDIC's *Case Manager Procedures* describes the Offsite Review Program and provides instructions for completing offsite reviews. Case Managers are responsible for ensuring that the supervisory strategies for institutions within their portfolios are appropriate and that institutions receive appropriate supervisory follow-up. Additional monitoring activities, expediting the examination schedule, or conducting a visitation to determine if a rating change should be initiated are examples of appropriate supervisory follow-up.

### Offsite Review Process

The Regional Office Management Information Group (ROMIG) located in each of the FDIC's Regional Offices administers the Offsite Review Program. ROMIG prepares a comprehensive list of institutions requiring offsite review for the quarter based on the ORL, Region-Added, and the SRL. The ROMIG forwards its comprehensive list of institutions requiring offsite review to the Case Managers and Assistant Regional Directors, along with offsite review deadlines and follow-up coding instructions. Case Managers use the Offsite Review Module on the Virtual Supervisory Information on the Net (ViSION) system to document their offsite reviews. See [Appendix 2](#) for details on offsite review follow-up coding in ViSION.

Case Managers do not follow a prescribed methodology in conducting offsite reviews. However, according to Case Managers we interviewed, an offsite review generally includes, but is not limited to, examining the IDI's Uniform Bank Performance Report<sup>10</sup> (UBPR), the most recent safety and soundness examination report, visitations and correspondence files, and contacting bank management or the PFR (when the FDIC is not the primary regulator).

### Timing of Offsite Reviews

The Case Manager must complete offsite reviews, and the Assistant Regional Director (ARD) must approve the offsite reviews within 3½ months after the Call Report date for each institution. Call Reports are completed 60 days after the report

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<sup>9</sup> Regional Offices are located in New York, New York; Atlanta, Georgia; Chicago, Illinois; Kansas City, Missouri; Dallas, Texas; and San Francisco, California.

<sup>10</sup> The Uniform Bank Performance Report is an analytical tool created for bank supervisory, examination, and management purposes. In a concise format, it shows the impact of management decisions and economic conditions on a bank's performance and balance-sheet composition.

## Offsite Reviews of 1- and 2-Rated Institutions

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cut-off date, generally allowing 45 days to conduct and approve the offsite reviews once Call Report data is available. The *Case Manager Procedures* requires that if onsite activity is recommended as a result of an offsite review, it should commence within 60 days of the approval date. An offsite review timeline is shown in Table 1.

**Table 1: Offsite Review Timelines**

Call Report Date	Call Report Data Available	Offsite Review Approved	Commencement of Onsite Activity
March 31	May 31	July 15	September 15
June 30	August 31	October 15	December 15
September 30	November 30	January 15	March 15
December 31	February 28	April 15	June 15

Source: *Case Manager Procedures*

### Offsite Review Management Reporting

Subsequent to each quarterly offsite review period, RMS headquarters staff prepares management reports providing results for (1) the ORL and Region-Added, and (2) the SRL. These reports summarize the various offsite review results from all Regions. The management reports include:

- The total number of institutions assigned for offsite review;
- The number of institutions that were downgraded;
- Risk trends identified in the specific quarter;
- Exception reports when the institution or PFR is not contacted by the Case Manager during an offsite review; and
- Historical tables on the models.

### FDIC Offsite Risk Committee and Other Supervisory Programs

An Offsite Risk Committee (ORC) meets twice annually as an information exchange and feedback mechanism with the purpose of “improving methods to identify the weakest or riskiest of better rated institutions.” For example, during ORC meetings, criteria for conducting offsite reviews based on the SRL might be adjusted. The Committee includes RMS specialists within each Region and FDIC Division of Insurance and Research (DIR) managers and specialists. The Committee discusses economic trends and the development of additional offsite monitoring models.

In addition to the Offsite Review Program, RMS uses other programs to monitor risks within the banking industry and to identify emerging issues and potential problems that may require supervisory attention. These programs include the Interim Contact Program; Large Insured Depository Institution (LIDI) Program; and Regional Risk Committees. Descriptions of these programs are provided in [Appendix 3](#).

### EVALUATION RESULTS

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The Offsite Review Program identified 1- and 2-rated institutions with emerging supervisory concerns related to rapid growth, noncore funding, deteriorating financial trends, or those identified and added by the Regional Offices. However, the FDIC should:

- Evaluate additional methods to identify institutions with other types of emerging supervisory concerns;
- Enhance the Offsite Review Procedures to provide detailed guidance for Case Managers regarding the offsite review process; and
- Provide Case Managers with additional training.

When an emerging supervisory concern was identified for 1- and 2-rated institutions, we found the FDIC appropriately adjusted its supervisory strategy in a timely manner; and the adjusted supervisory strategies were effective.

#### **The FDIC Should Evaluate Additional Methods to Identify 1- or 2-Rated Institutions with Other Types of Emerging Supervisory Concerns**

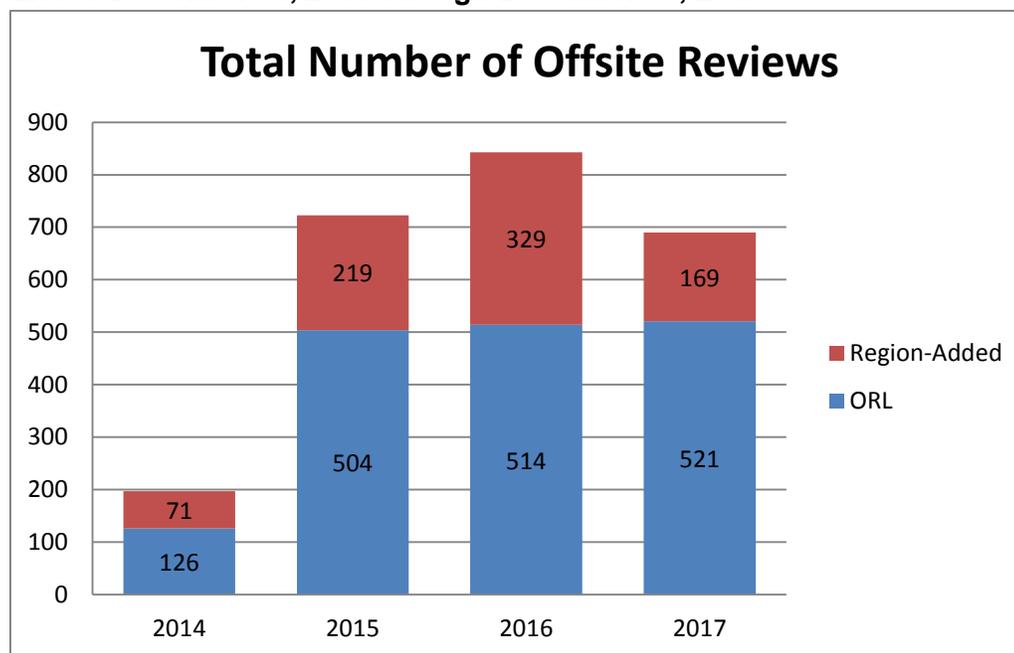
The FDIC developed the Offsite Review Program to identify emerging supervisory concerns and potential problems so that supervisory strategies could be adjusted appropriately. Currently, the Program relies on Call Report data, Regional concerns, and supplemental programs to identify institutions for offsite review. Because the Offsite Review Program is an important component of the FDIC's supervisory program, it should be continually enhanced by incorporating innovative methodologies for identifying institutions with various types of emerging supervisory concerns so that supervisory strategies can be adjusted appropriately. Further, the FDIC Chairman encourages the FDIC's adoption of new technologies to enhance the FDIC's internal processes, especially for supervision. The Chairman's Message in the 2019 FDIC Annual Performance Plan included that:

As the banking industry evolves, so must the FDIC. That is why I have directed FDIC leadership to conduct a comprehensive review of our current supervisory processes, as well as the organization, workforce structure, and capabilities supporting our supervisory mission. Through focused adoption of new technologies and processes, we can improve the transparency, efficiency, and effectiveness of our consumer and prudential examinations.

Case Managers conducted 1,665 offsite reviews based on the ORL (SCOR, SCOR-Lag, and GMS factors) and 788 that were Region-Added for the quarters ended

December 31, 2014 through December 31, 2017. Figure 1 indicates the year of the quarter when Case Managers conducted these offsite reviews.

**Figure 1: ORL and Region-Added Offsite Reviews Conducted as of Quarters Ended December 31, 2014 through December 31, 2017**



Source: OIG analysis of ViSION and offsite review data provided by the RMS Risk Analysis Section.  
Note: Data for 2014 only includes offsite reviews conducted based on the 12/31/2014 Call Report.

We determined that only 47 of the 1,665 offsite reviews conducted based on the ORL (3 percent) resulted in an adjustment to the supervisory strategy. This means that 97 percent of the offsite reviews confirmed that the existing supervisory strategy for these banks was appropriate and did not need to be adjusted. Given the stated purpose of the program to “identify emerging supervisory concerns and potential problems so that supervisory strategies could be adjusted appropriately,” the FDIC should explore additional methods for identifying emerging supervisory concerns and creating the ORL as discussed below.

### Downgraded Institutions

From December 31, 2014 through December 31, 2017, 244 1-or 2-rated IDIs received composite downgrades to a 3- or 4-rating. Of these, SCOR, SCOR-Lag, and GMS identified 67 of the downgraded institutions at some point during this 3-year period. An additional 27 downgraded institutions were on the SRL or Region-Added. As a result, the Offsite Review Program in total identified 39 percent (94 of 244) of the number of 1- or 2-rated institutions downgraded from December 31, 2014 through December 31, 2017.

## Offsite Reviews of 1- and 2-Rated Institutions

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Conversely, this means the Offsite Review Program did not identify 61.5 percent (150 of 244) of the 1- or 2-rated institutions downgraded from December 31, 2014 through December 31, 2017. This led us to explore the factors that led to the downgrades of these institutions that were not identified by the Offsite Review Program. Table 2 includes these factors.

**Table 2: Factors Contributing to Downgrades of 150 IDIs Not Identified by the Offsite Review Program from December 31, 2014 through December 31, 2017**

<b>Causes</b>	<b>Number of Institutions Impacted</b>
Weak Management	72
Weak Credit Administration	53
Declining Asset Quality	53
Weak Board Oversight	44
Poor Earnings	36
Bank Secrecy Act Weaknesses	29
Allowance for Loan and Lease Losses	27
Deficient Liquidity	22
Inadequate Capital	20
Excessive Growth Strategy	11
Sensitivity/Interest Rate Risk	9
Commercial Real Estate Concentration	6
Internal Control Weaknesses	5

Source: OIG analysis of RMS offsite review management reports.

Note: Multiple factors can contribute to an institution's downgrade.

Current RMS models and methodologies, such as SCOR and GMS primarily rely on Call Report data.<sup>11</sup> A limitation with these financial models is that they are dependent on what financial institutions report. Using this data alone, the FDIC was unable to identify many significant non-financial issues that were identified during onsite examinations, such as Weak Management, Weak Credit Administration, Declining Asset Quality, and Weak Board Oversight and later led to downgrades.

Onsite examinations of financial institutions provide key assessments of bank operations and controls such as management's ability to manage risk. Onsite examinations also determine whether assets are being properly underwritten and are of an acceptable level of quality. Reports of Examination contain the results of these assessments. If the FDIC included Reports of Examination in the offsite monitoring models, the program may be able to identify more factors leading to institution downgrades (emerging supervisory concerns). For example, the FDIC offsite

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<sup>11</sup> Approximately 25 percent of the institutions in the table above filed Call Report Amendments to correct errant data.

monitoring models could use software that scans successive Reports of Examination for key phrasing such as Weak Management, Weak Credit Administration, Declining Asset Quality, or Weak Board Oversight to identify ongoing concerns or trends at an institution that may not be reflected in its current rating.

FDIC officials advised that they are currently working on alternative offsite monitoring models to improve the Offsite Review Program. Such efforts should be continued, as additional methods and innovative technologies could be beneficial in identifying additional emerging supervisory concerns offsite. As discussed later in our report, when an emerging supervisory concern was identified, RMS adjusted the FDIC's supervisory strategies in a timely manner, and the adjusted strategies were effective. Therefore, if the program is able to identify more of the factors leading to institution downgrades (emerging supervisory concerns); the effectiveness of the FDIC's supervision of IDIs could also improve.

### Recommendation

We recommend that the Director, RMS:

1. Evaluate the feasibility of using additional methods and innovative technologies to identify 1- and 2-rated institutions with other types of emerging supervisory concerns.

### The FDIC Should Enhance Procedures to Improve the Offsite Review Process

The FDIC should enhance its Offsite Review Program procedures to provide additional guidance for Case Managers regarding the scope and methodology of an offsite review. The *Standards for Internal Control in the Federal Government* issued by the Comptroller General of the United States (*GAO Internal Control Standards*) states that the effectiveness and efficiency of operations is affected by an entity's internal control system, which comprises the plans, methods, policies, and procedures used to fulfill the mission, strategic plan, goals, and objectives of the entity. Control activities include the policies and procedures that enforce management's directives to achieve the entity's objectives and address related risks.

### Scope and Methodology of an Offsite Review

The *Case Manager Procedures* provides a general overview of the Offsite Review Program. However, these procedures do not include guidance regarding the scope or methodology for conducting an offsite review, specific information to be reviewed, or the extent of the review. Therefore, Case Managers are applying the Offsite Review Program inconsistently. For example, some Case Managers limit their

review to ratios related to the specific reason that the institution was selected for offsite review, while others conduct an extensive review including all significant financial ratios.

We interviewed 32 Case Managers regarding the average time and procedures involved in conducting an offsite review. According to six Case Managers, the average time for a first-time review of an institution was 4 hours or less. In contrast, another five Case Managers advised that they may spend 12 hours conducting a first-time offsite review. For institutions where the Case Manager had recently conducted an offsite review, making them already familiar with the bank's operations, eight Case Managers advised that they spend no more than an hour conducting the offsite review while seven said they spend over 4 hours. These variances in review times indicate that the time spent is not consistent among Case Managers.

In addition, regardless of whether it was a first-time review or a recurring review, the level of effort varied among Case Managers. Twenty Case Managers advised that their offsite review procedures were limited to assessing the bank based on the reason it was triggered for an offsite review. In contrast, 12 Case Managers said that they did not limit the offsite review to the reason that the bank was placed on the ORL but would assess the bank's overall operations. The variance in review procedures from Case Manager to Case Manager indicates inconsistencies in the depth of offsite reviews performed.

By providing additional guidance as to the information to be reviewed and extent of the work to be conducted, Case Managers can conduct offsite reviews in a consistent manner and may improve the efficiency of the Offsite Review Program. In addition, the FDIC would have greater assurance that Case Managers are properly utilizing their time, and Case Managers would have greater assurance that they are conducting their work in accordance with FDIC management's expectations.

### **Recommendation**

We recommend that the Director, RMS:

2. Provide guidance on the scope and methodology to be applied when conducting an offsite review.

### **The FDIC Should Provide Offsite Review Training**

The *GAO Internal Control Standards* provide that among other things, management should develop competent personnel to achieve the entity's objectives. This includes providing training to enable individuals to develop competencies appropriate for key roles and tailoring training based on the needs of the role.

### **Training Needed to Ensure Review Consistency**

The FDIC provided mandatory training for Case Managers in 2017 that included a session covering the offsite review models and case studies on documenting offsite review narratives; and, in 2018, covering the SCOR-Lag methodology. Case Managers we interviewed indicated that these sessions were beneficial.

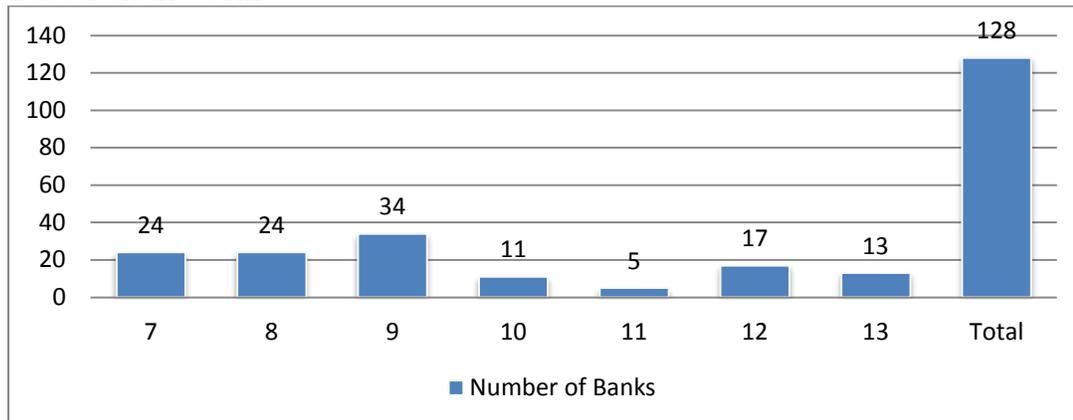
However, 31 of 32 Case Managers stated that they had not received any Offsite Review training that provided specific guidance on the scope and methodology of the procedures for conducting an offsite review. These Case Managers explained that they either learned the procedures to conduct an offsite review from another Case Manager and/or used the help feature in ViSION to understand the process. Twenty-one of 32 Case Managers we interviewed, or 66 percent, indicated that additional training on the Offsite Review Program specific to the procedures they were expected to perform would be beneficial. RMS should provide training to ensure that management's expectations are understood regarding the level of effort and depth of the offsite review procedures conducted.

### **Training Needed on the Importance of Reviewing Institutions Recurring on the ORL**

RMS management advised us that Case Managers are required to conduct offsite reviews on IDIs regardless of whether prior offsite reviews were conducted involving the same concern. As shown in Figure 2, 128 institutions appeared on the ORL at least 7 of the 13 quarters we reviewed from December 31, 2014 through December 31, 2017.

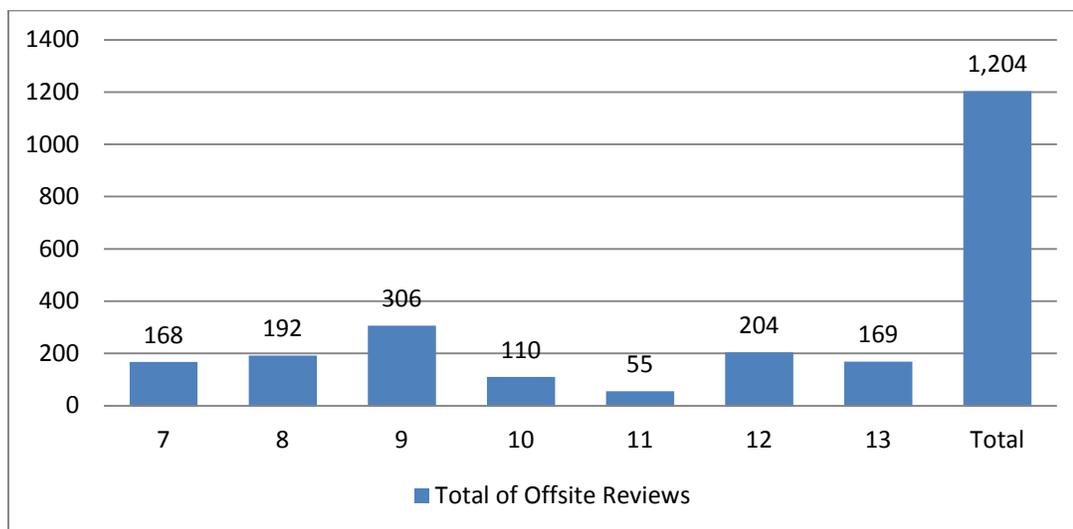
As a result, as shown in Figure 3, Case Managers conducted a total of 1,204 offsite reviews at these 128 institutions. Only 7 of these 1,204 offsite reviews (0.60 percent) resulted in a recommendation for onsite activity, and only 3 of the institutions (0.25 percent) were rated as high-risk at the time of the offsite review. Appendix 4 shows the number of offsite reviews based on the ORL for all 13 quarters.

**Figure 2: Institutions Requiring Offsite Review 7 or More Quarters Based on the ORL**



Source: ORLs from December 31, 2014 through December 31, 2017.

**Figure 3: Offsite Reviews Conducted on Institutions 7 or More Quarters Based on the ORL**



Source: OIG Analysis of ORLs from December 31, 2014 through December 31, 2017.

Twenty-two of 32 Case Managers (69 percent) we interviewed indicated that the Offsite Review Program would be more effective if it did not include institutions recurring on the ORL consecutive quarters without a new emerging concern. Case Managers advised that recurring institutions were often placed on the ORL by GMS due to a high non-core funding structure or rapid growth in a new asset type. While these are risks that should be investigated, Case Managers stated that it was not an effective use of their time to repeatedly review the same institution each quarter after they had recently determined that the risk associated with the funding structure or growth was properly managed. Case Managers suggested that it would be more productive to work on other institutions in their portfolios, rather than repeatedly

conducting and documenting offsite reviews for a concern on an institution they had recently assessed.

RMS senior management, however, advised that the offsite review models identify outliers in the industry each quarter related to financial deterioration and rapid growth. According to RMS senior management, it is rare for banks to file Call Reports with identical information from one quarter to the next. Therefore, RMS management stated it is important that Case Managers determine why a bank is identified as an outlier regardless of the number of times it is flagged for offsite review. For example, RMS senior management stated that GMS is a 3-year forward looking model and industry outliers with continuous consecutive quarters of rapid growth and high noncore funding structures are worthy of review. RMS senior management emphasized that to exclude outliers merely for repeat occurrences on the ORL violates sound risk management principles.

While we understand why the Case Managers would deem recurring reviews to be an ineffective use of their time, during our evaluation, RMS senior management clearly explained the value of these reviews. Therefore, we concluded that the Case Managers need training to ensure they understand the importance of conducting recurring offsite reviews.

### **Incorrect Coding of Offsite Reviews Addressed by Mandatory Case Manager Training**

We found that Case Managers improperly coded offsite follow-up activity codes, which led to inaccurate reporting of program results to the RMS Director. The inaccurate reporting overstated the number of institutions for which the supervisory strategy was adjusted as a result of the offsite review program.

The *Case Manager Procedures* instructs Case Managers to use the ViSION follow-up codes: “None,” “Continued Monitoring,” and “Onsite Activity” to indicate the supervisory strategy recommended for the institution based on the results of the offsite review. The definitions of those follow-up codes are:

**None** should be used if no concerns are identified given the level and trend of risk, the primary regulator is addressing the issue or situation, or activity scheduled by the primary regulator is within an acceptable timeframe given the situation. The comments should reflect any ongoing activity.

**Continued Monitoring** should be used if the primary regulator is monitoring a situation but waiting for additional information (something is unknown), or the institution is being added to the Region’s watch list.

**Onsite Activity** should be used if the FDIC believes conditions warrant acceleration of supervisory activity (examination or visitation) of an FDIC-supervised institution based on the risk identified during the offsite review. This code should not be used for regularly scheduled supervisory activity.

From December 31, 2014 through December 31, 2017, Case Managers used the incorrect supervisory strategy follow-up code for 52 of the 112 (46 percent) offsite reviews conducted based on the ORL or added by the Regional Offices. For example, Case Managers incorrectly used the “Onsite Activity” code when a regularly scheduled examination was already ongoing or was to begin within the next quarter. In these instances, “None” would have been the correct code. Case Managers advised that they misunderstood the proper codes to use.

Due to the inaccurate reporting, the amount of onsite activity -- prompted as a result of the Offsite Review Program -- was overstated by 46 percent during the 3-year period of our review. We did not recommend training to address these specific errors, as Case Managers were provided mandatory training that covered the proper use of codes in 2017 subsequent to when these coding errors occurred.

### **Recommendation**

We recommend that the Director, RMS:

3. Provide Offsite Review Program training for Case Managers to ensure consistent application of offsite review procedures and to ensure Case Managers understand the importance of conducting offsite reviews on institutions that recur on the ORL.

### **The FDIC Adjusted Supervisory Strategies in a Timely Manner and the Adjusted Supervisory Strategies Were Effective**

Based on our review of the offsite review completion dates recorded in VISION, we found that 1,665 offsite reviews conducted based on the ORL from December 31, 2014 through December 31, 2017 were approved within the timeframes that RMS established. We also determined that 21 offsite reviews that identified emerging supervisory concerns resulted in adjusted supervisory strategies. Furthermore, examiners initiated 21 of the adjusted supervisory strategies (onsite activities) as a result of an offsite review within the required 60 days of the offsite review approval date. These 21 expedited visitations or examinations resulted in recommendations to correct deficiencies. A review of subsequent examinations found that bank management addressed examiners’ recommendations related to the onsite activities, resulting in improvements in the bank’s operations in each of the 21 institutions.

Additionally, seven of the expedited onsite reviews resulted in component downgrades, and three of these institutions also received a composite downgrade.

Based on these results, we found that the adjusted supervisory strategies implemented as a result of the Offsite Review Program were conducted in a timely manner, and the adjusted supervisory strategies were effective.

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## FDIC COMMENTS AND OIG EVALUATION

On December 16, 2019, the Director, RMS, on behalf of the FDIC, provided a written response to a draft of this report (FDIC Response), which is presented in its entirety in Appendix 5.

The FDIC concurred with the three recommendations made in this report and stated it is committed to monitoring bank risk both onsite and offsite.

The FDIC agreed to undertake the following actions to address the three recommendations:

- Evaluating the feasibility of using additional methods and innovative technologies to identify 1-and 2-rated institutions with other types of emerging supervisory concerns by exploring the use of machine learning in early warning models.
- Providing guidance on the scope and methodology to be applied when conducting an offsite review by evaluating the case manager procedures and instructions to ensure they provide guidance of expectations and content of reviews.
- Providing Offsite Review Program training for Case Managers on the updated instructions and guidelines to ensure consistent application of offsite review procedures. In addition, the training will cover the analysis of risk characteristics for banks identified for reviews over recurring periods to ensure Case Managers understand the importance of conducting offsite reviews on institutions that recur on the ORL.

These planned actions are responsive to Recommendations 1, 2, and 3; therefore, we consider these recommendations to be resolved. The recommendations will remain open until the OIG confirms that corrective actions have been completed and are responsive.

## Objectives

The objectives of our evaluation were to assess whether (1) the Offsite Review Program identified 1- and 2-rated institutions with emerging supervisory concerns; (2) the Offsite Review Program resulted in the FDIC appropriately adjusting the supervisory strategies for these institutions in a timely manner; and (3) the adjusted supervisory strategies were effective.

## Scope

The scope of our evaluation included 1- and 2-rated IDIs on the ORL or added by Regional Offices for offsite review from December 31, 2014 through December 31, 2017. We did not review or test offsite reviews of 1- and 2-rated institutions that were based on the SRL. Our work related to the SRL was limited to determining the number of institutions identified by the SRL that were downgraded.

## Methodology

To accomplish our objectives, we conducted the following procedures covering the scope of the evaluation.

- Reviewed follow-up coding for offsite reviews based on the ORL and Region-Added;
- Analyzed ORL trends from December 31, 2014 through December 31, 2017;
- Analyzed all 1- and 2-rated institutions whose composite CAMELS ratings were downgraded and determined whether they were targeted for an offsite review based on the ORL, Region-Added, or based on the SRL;
- Determined the total number of Region-Added institutions. Documented the reason the institution was added to the ORL, the outcome of the offsite review, and if any of the reviews resulted in onsite activity;
- Analyzed the number of times institutions appeared on the ORL from December 31, 2014 through December 31, 2017 and how often recurring reviews resulted in the FDIC recommending onsite activity;
- Reviewed completion and approval dates in ViSION to determine whether they were within the 105-day timeframe established by the *Case Manager Procedures*;
- Evaluated timeframes for the implementation of visitations or expedited examinations and determined whether the onsite activity commenced within the 60-day timeframe established by the *Case Manager Procedures*;
- Analyzed the subsequent 2-year period following the onsite activity to determine whether any composite or component ratings changed;

- Determined how many of the institutions with onsite activity had significant changes in ratings and/or tool metrics and reviewed recommendations or other comments to bank management to assess the effectiveness of the change in the supervisory strategy;
- Reviewed failed institutions and determined when the institution had at least a composite 2 rating and identified if the institution was on the ORL;
- Determined whether the FDIC validated its offsite monitoring models in accordance with FDIC policies;
- Reviewed Validation reports for SCOR, GMS, and REST; and
- Reviewed reasons institutions not identified by the ORL were downgraded.

We reviewed the following statutes, regulations, and FDIC guidance:

- Chapter 13 of the *Case Manager Procedures*;
- RMS Memorandum on ROMIG Charter, dated October 11, 2000;
- OMB Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*, dated June 6, 2018;
- Government Accountability Office *Standards for Internal Control in the Federal Government*, dated September 2014; and
- GPRA Modernization Act of 2010.

We reviewed the following background documents:

- FDIC Banking Review 2003, Volume 15, No. 3, report titled: *The SCOR System of Off-Site Monitoring: Its Objectives, Functioning, and Performance*;
- FDIC's RMS 2013-2017 Strategic Plan;
- FDIC OIG Audit Report No. 02-033 titled: *Statistical CAMELS Offsite Rating Review Program for FDIC-Supervised Banks*, dated September 26, 2002;
- FDIC OIG Audit Report No. 09-004 titled: *FDIC's Controls Related to the Offsite Review List*, dated February 2009;
- FDIC's Interagency Memorandum of Understanding on Special Examinations, dated July 14, 2010;
- RMS Offsite Review Findings Memorandums from December 31, 2014 through December 31, 2017;
- DIR's 2018 Goals and Strategies; and
- DIR's Hot Topics titled: *What is the Growth Monitoring System?* dated July 12, 2018.

We interviewed the following officials and organizations:

- Chief, RMS Risk Analysis Section;
- Deputy Director, San Francisco Regional Office;
- Assistant Regional Directors, Chicago, Dallas, and San Francisco Regional Offices;

- ROMIG Officials in the Atlanta, New York, Chicago, Kansas City, Dallas, and San Francisco Regional Offices; and
- DIR Officials in the Financial Modeling and Research Group.

Case Managers are required to designate the institution's Level of Risk as Low, Medium, or High in the ViSION Offsite Review Module based on the results of the offsite review. The available codes are shown below.

<b>Level of Risk</b>	<b>Description</b>
Low	Current or prospective exposure to loss of earnings or capital is minimal. Overall risk exposures reflect conservative structure with sound policies and exposures managed and understood by management. Risk exposures represent a well-diversified portfolio of stable credits and/or markets. Risk from concentrations is minimal. The balance sheet growth presents no concerns. Expected/potential problems can be resolved in the normal course of business, with little impact to earnings or capital.
Medium	Current or prospective exposure to loss of earnings or capital does not materially impact the institution's financial condition. Overall risk exposures reflect an acceptable balance sheet structure with sound policies and exposures that are managed and understood by management. Risk exposures may arise from limited exceptions or overrides to sound standards, or identified weaknesses in credits or the bank's local markets, and could pose a risk concern. Potential risk from concentrations exists but is manageable in the normal course of business, and management is knowledgeable and monitoring the exposure. The balance sheet growth could be high but is adequately managed and presents few concerns. Expected/potential problems can be resolved with short-term impacts to earnings and possibly capital, but continued viability is not a concern.
High	The current or prospective exposures pose a risk of loss to earnings or capital that could materially impact the institution's financial condition. Overall risk exposures reflect an aggressive balance sheet structure, weak policies and/or credit administration, or poor management oversight. Risk exposures may arise from exceptions or overrides to sound standards, or identified weaknesses in credits or the bank's local market, and could pose significant or advanced concerns. Potential risk from concentrations exists, and management is not adequately monitoring the levels. The balance sheet growth is not consistent with the risk profile or business operations of the institution. Potential problems could impact earnings and capital. Viability of the institution could become a concern.

Case Managers are required to designate the institution's Risk Trend in the ViSION Offsite Review Module based on the results of the offsite review. The Risk Trend is the probable change in the institution's risk profile over the next 12 months based on the result of the offsite review. The trend should be based on the Case Manager's expectations of policies, controls, and management oversight.

<b>Risk Trend</b>	<b>Description</b>
Decreasing	If the reviewer expects the overall risk to decline over the next 12 months.
Stable	If the reviewer expects the overall risk to remain unchanged over the next 12 months.
Increasing	If the reviewer expects the overall risk to be higher in the next 12 months.

Case Managers are required to designate the recommended follow-up action based on the results of the offsite review. The code definitions are shown below.

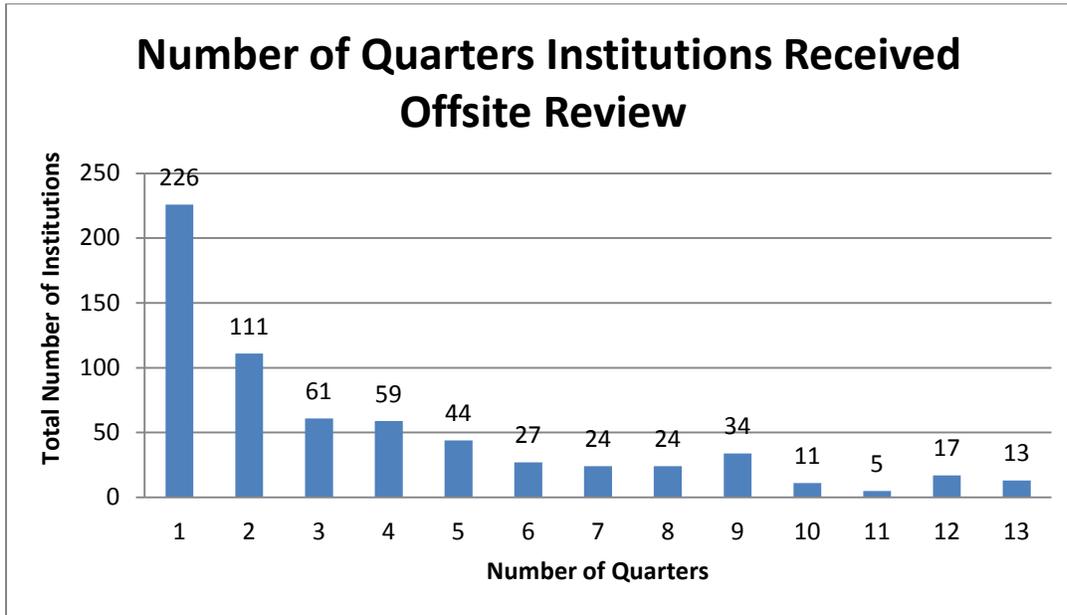
<b>Supervisory Strategy Follow-up Code</b>	<b>Description</b>
None	No concerns are identified given the level and trend of risk, the primary regulator is addressing the issue or situation, or activity scheduled by the primary regulator is within an acceptable timeframe given the situation.
Continued Monitoring	The primary regulator is monitoring the situation but waiting for additional information (something is unknown), or the institution is being added to the Region's watch list.
Onsite Activity	The FDIC believes conditions warrant acceleration of supervisory activity (examination or visitation) of an FDIC-supervised institution based on the level of risk identified during the offsite review. This should not be used for regularly scheduled supervisory activity.

In addition to the Offsite Review Program, the FDIC uses several other programs to monitor risks within the banking industry and to identify emerging concerns that may require supervisory follow-up. These programs include those described below.

<b>Offsite Supervisory Programs</b>	<b>Description</b>
Interim Contact Program	For institutions that do not receive an offsite review, Case Managers contact FDIC-supervised institutions at least once during the interval between FDIC Risk Management examinations. The objective of the contact is to maintain communication with the institution by providing an opportunity for an institution's management to discuss developing issues and regulatory guidance and rules that may impact the institution.
Large Insured Depository Institution Program	The Offsite Review Program only includes 1- or 2-rated institutions under \$10 billion. The LIDI program involves quarterly offsite review for institutions rated "3", "4", or "5" and with more than \$4 billion in assets and all institutions with more than \$10 billion in assets, including non-FDIC regulated institutions.
Regional Risk Committees	Regional Risk Committees meet regularly to discuss current and emerging risks and to rank them in order of priority. These risks are monitored on an interdivisional basis, and material concerns are conveyed to the FDIC's National Risk Committee.

From December 31, 2014 through December 31, 2017, 656 institutions appeared on the ORL. The figure below shows the number of times these institutions recurred on the ORL over these 13 quarters.

Number of Quarters Institutions Received Offsite Review



Source: ORLs from December 31, 2014 through December 31, 2017.



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Division of Risk Management Supervision

DATE: December 13, 2019

TO: Terry L. Gibson  
Assistant Inspector General, Program Audits and Evaluations  
FDIC Office of Inspector General

FROM: Doreen R. Eberley /signed/  
Director

SUBJECT: OIG Draft Evaluation Report - Offsite Reviews of 1- and 2-Rated Institutions  
Assignment No. 2018-010

The Federal Deposit Insurance Corporation (FDIC) appreciates the opportunity to comment on the draft evaluation report (Draft Report) for assignment No.2018-010. The Draft Report evaluated the Offsite Review Program for identification of emerging supervisory concerns and the adjustment and effectiveness of supervisory strategies of 1- and 2-rated institutions. The FDIC agrees with the conclusion that *"the Offsite Review Program identified 1- and 2-rated institutions with emerging supervisory concerns related to rapid growth, noncore funding, deteriorating financial trends, or those identified and added by the Regional Offices."* The offsite review program is an integral part of the risk assessment of banks and in concert with the examination process and other risk identification procedures, provides the FDIC with valuable tools to monitor emerging risk in banks.

The FDIC is committed to monitoring bank risk both onsite and offsite and agrees with the recommendations below.

**Recommendation 1 - Evaluate the feasibility of using additional methods and innovative technologies to identify 1- and 2-rated institutions with other types of emerging supervisory concerns.**

Concur. The FDIC is committed to continuously exploring statistical processes to improve our capabilities. We are currently exploring the use of machine learning in early warning models. The FDIC already uses a similar approach to identify banks for potential fraud, and a tool to analyze natural language in information technology examination workpapers.

**Recommendation 2 - Provide guidance on the scope and methodology to be applied when conducting an offsite review.**

Concur. The FDIC will evaluate the case manager procedures and instructions for the general scope and methodology of offsite reviews to ensure they provide guidance of expectations and content of reviews.

**Recommendation 3 - Provide Offsite Review Program training for Case Managers to ensure consistent application of offsite review procedures and to ensure Case Managers understand the importance of conducting offsite reviews on institutions that recur on the ORL.**

Concur. As mentioned in the previous recommendation, the FDIC is in the process of evaluating and updating instructions and guidelines which will be used in case manager training. In addition, the training will cover analysis of risk characteristics for banks identified for reviews over recurring periods.

This table presents management's response to the recommendations in the report and the status of the recommendations as of the date of report issuance.

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved: <sup>a</sup> Yes or No	Open or Closed <sup>b</sup>
1	The FDIC is currently exploring the use of machine learning in early warning models. The FDIC already uses a similar approach to identify banks for potential fraud, and a tool to analyze natural language in information technology examination workpapers.	12/15/2020	\$0	Yes	Open
2	The FDIC will evaluate the case manager procedures and instructions for the general scope and methodology of offsite reviews to ensure they provide guidance of expectations and content of reviews.	06/30/2020	\$0	Yes	Open
3	The FDIC is in the process of evaluating and updating instructions and guidelines which will be used in Case Manager training. In addition, the training will cover analysis of risk characteristics for banks identified for reviews over recurring periods.	06/30/2020	\$0	Yes	Open

<sup>a</sup> Recommendations are resolved when -

1. Management concurs with the recommendation, and the planned, ongoing, and completed corrective action is consistent with the recommendation.
2. Management does not concur with the recommendation, but alternative action meets the intent of the recommendation.
3. Management agrees to the OIG monetary benefits, or a different amount, or no (\$0) amount. Monetary benefits are considered resolved as long as management provides an amount.

<sup>b</sup> Recommendations will be closed when the OIG confirms that corrective actions have been completed and are responsive.



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