



Forward-Looking Supervision

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Evaluation Report Program Audits and Evaluations





Executive Summary

Forward-Looking Supervision

The Federal Deposit Insurance Corporation (FDIC) adopted a risk-focused supervision program in 1997 and in 2011, the FDIC implemented a Forward-Looking Supervisory initiative as part of its risk-focused supervision program. The goals of this supervisory approach are to identify and assess risk before it impacts a financial institution's financial condition and to ensure early risk mitigation. Prior to the financial crisis of 2008-2011, examiners often identified weak risk management practices at financial institutions, but they delayed taking supervisory action until the institution's financial performance declined. Forward-Looking Supervision seeks to avoid this result.

Assets that share similar risk characteristics held by financial institutions in significant amounts create concentrations. Concentrations create a dimension of risk that financial institution management must consider for its risk management policies. Our evaluation studied institutions with Commercial Real Estate (CRE) and Acquisition, Development, and Construction (ADC) loan concentrations that had recently experienced high loan growth. In the event of an economic downturn, institutions with poorly managed concentrations are more vulnerable to financial losses and failure than other institutions with well managed concentrations. Such a failure causes losses to the FDIC's Deposit Insurance Fund (DIF) which provides funds to resolve failed banks and is administered by the FDIC. According to FDIC data, from January 2007 to December 2013, poorly managed concentration risk contributed to (1) CRE and ADC loan losses of \$120.6 billion, (2) the failure of 492 financial institutions, and (3) \$74.6 billion in losses to the DIF.

Our evaluation objective was to determine whether the Forward-Looking Supervision approach achieved its outcomes—the Division of Risk Management Supervision (RMS) pursued supervisory action upon identifying risks and the financial institutions implemented corrective measures.

Results

Our review showed that examiners substantially achieved the intended outcomes of the Forward-Looking Supervision approach for our sampled institutions. Examiners applied Forward-Looking Supervision concepts during their financial institution examinations, rated institutions based on risk, and recommended corrective actions

based on their risk assessments. Also, the financial institutions committed to implement the corrective actions.

We found that the FDIC did not have a comprehensive policy guidance document on Forward-Looking Supervision and should clarify guidance associated with its purpose, goals, roles, and responsibilities. The FDIC should have such guidance to institutionalize the Forward-Looking Supervision approach and to help to ensure its application regardless of economic conditions and FDIC management prerogatives.

Examiners typically documented their overall conclusions regarding the financial institutions' concentration risk management practices in the Report of Examination. However, we identified instances in which examiners did not always document certain Forward-Looking Supervision concepts consistent with examiner guidance, when planning an examination and when reporting examination results. For example, 74 percent of examination reports we reviewed either did not include a complete written analysis or did not provide conclusions regarding specific categories of the institution's concentration risk management practices. This level of detail provides assurance that examiners have applied and communicated Forward-Looking conclusions. Undocumented analysis creates the risk that examiners may not have sufficiently analyzed financial institution mitigation efforts for asset concentrations. Absent sufficient analysis, examiners may not reach the conclusions necessary to recommend needed corrective actions to the financial institutions. Further, without thorough documentation, supervisory examiners and case managers may find it difficult to assess risk and direct supervisory efforts to mitigate that risk.

We found that examiners typically reported or elevated identified overall concentration risk management conclusions and concerns into various parts of the examination report, depending on the degree of supervisory concern. However, only 27 percent of reports sampled elevated concerns to the financial institution's board of directors within the examination report. Based on the financial institutions' concentration levels, recent loan growth, and concentration risk management weaknesses, we believe that a greater number of these concerns warranted board attention. Communication is a critical tool to successful forward-looking, risk-focused supervision. Elevating concerns and recommendations provides greater visibility and awareness to the financial institution's board of directors and senior management.

We found that examiners generally identified concentration risk management concerns on a timely basis. However, we noted five instances (15 percent) in which examiners identified fundamental concentration risk management concerns that had

not been identified during the prior examination cycle. If the same concentration risk management practices existed during both examination cycles, then examiners either did not perform required analysis that may have identified the concerns or did not perform sufficient analysis to identify concerns that should have been apparent. Delayed risk identification and mitigation efforts decrease the potential effectiveness of the Forward-Looking Supervision approach. These delays can hinder the financial institution's ability to implement corrective actions in a stressed financial condition or operational environment.

We found that when the FDIC expressed a concern and recommended a concentration risk management practice, financial institutions typically committed to undertake corrective action. Financial institutions that commit to and undertake timely corrective action decrease the risk that they may incur a significant financial loss in a stressed financial condition or operational environment.

Recommendations

We recommend that the Director, RMS: (1) issue a comprehensive policy guidance document defining Forward-Looking Supervision, including its purpose, goals, roles, and responsibilities; (2) issue guidance to reinforce how and where examiners should be documenting concentrations and an institution's concentration risk management practices in the report of examination; (3) provide additional case studies on Forward-Looking Supervision to strengthen training for examiners on the analysis and identifications of potential financial institution risk management weaknesses; and (4) conduct recurring retrospective reviews to validate that examiners thoroughly documented their written analyses of the financial institutions' practices regarding concentration risk management.

Contents

Background	2
Evaluation Results	5
Need for Policy Statement	7
Forward-Looking Supervision Techniques Applied	8
Elevating Concerns within Examination Reports	17
Identification of Concentration Concerns in Timely Manner	21
Financial Institutions Respond to Examiner Recommendations	24
FDIC Comments and OIG Evaluation	26

Appendices

1. Objective, Scope, Methodology	27
2. Glossary	30
3. Acronyms and Abbreviations	32
4. Potential Obstacles to Corrective Action	33
5. FDIC Comments	35
6. Summary of the Corporation's Corrective Action	37

Figures

1. Select CRE and ADC Loan Product Growth	4
2. Forward-Looking Supervision Approach Outcomes	5
3. Planning and Documenting Risk Indicators	11
4. Communicating Concentration Risk Management Concerns	20
5. Timely Identification of Concentration Risk Management Concerns	23



August 8, 2018

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Subject | *Forward-Looking Supervision*

The goals of the FDIC's Forward-Looking Supervisory approach are to identify and assess risk before it impacts a financial institution's financial condition and to ensure early risk mitigation. Our evaluation focused on the FDIC's implementation of Forward-Looking Supervision in 54 financial institutions with concentrations in Commercial Real Estate (CRE) or Acquisition, Development, and Construction (ADC) loans. Such concentrations can make institutions more vulnerable to economic downturns affecting a geographic region or industry. According to a Government Accountability Office (GAO) report, between 2008 and 2011, failures of small and medium-sized financial institutions¹ were largely associated with (1) high CRE loan concentrations, and in particular, ADC loans, (2) inadequate risk management, (3) aggressive growth strategies using nontraditional, riskier funding sources, and (4) weak loan underwriting and credit administration practices.²

Our evaluation objective was to determine whether the Forward-Looking Supervision approach achieved its outcomes—the Division of Risk Management Supervision (RMS) pursued supervisory action upon identifying risks and the financial institutions implemented corrective measures. To address our objective, we reviewed FDIC documentation supporting planning, implementing, and reporting on the supervisory examinations for sampled institutions. In particular, we focused on the examiners' use of the revised Concentrations page,³ a required written analysis to assess concentration risk management in a Report of Examination. We also interviewed RMS examiners, field office supervisors, case managers, and regional management to obtain their perspectives on Forward-Looking Supervision.

We conducted this evaluation in accordance with the Council of the Inspectors General on Integrity and Efficiency *Quality Standards for Inspection and Evaluation* (January 2012). [Appendix 1](#) of this report includes additional details on our objective, scope, and methodology. [Appendix 2](#) contains a glossary of key terms,⁴ and [Appendix 3](#) contains a list of acronyms.

¹Small financial institutions are banks with average assets of less than \$1 billion, and medium-sized financial institutions are banks with average assets of at least \$1 billion and less than \$10 billion.

²See U.S. GAO Report, GAO-13-71, *Financial Institutions: Causes and Consequences of Recent Bank Failures* (January 2013).

³Examiners use the Concentrations page to identify asset and liability concentrations and evaluate the institution's related risk management practices for certain concentrations.

⁴Certain terms that are underlined when first used in this report are defined in [Appendix 2](#), *Glossary of Terms*.

Background

The FDIC adopted a risk-focused supervision program in 1997 and began to re-emphasize Forward-Looking aspects of the risk-focused examination process in 2009. In 2011, the FDIC implemented a Forward-Looking Supervisory initiative as part of its risk-focused supervision program. Forward-Looking Supervision identifies and mitigates risk management weaknesses before they impact the financial condition of an institution. FDIC reemphasized Forward-Looking Supervision following an assessment of its supervisory activities after the 2008 – 2011 financial crisis.

Prior to the financial crisis, examiners often identified weak risk management practices at financial institutions, but they delayed taking supervisory action until the institutions' financial performance declined. Weak risk management practices often provide early warning signals of future financial decline. Supervisory action often came too late to significantly mitigate risk. Forward-Looking Supervision seeks to avoid this result.

Assets that share similar risk characteristics held by financial institutions in significant amounts create asset concentrations. A concentration can also occur when liabilities come from one, or few, sources and reflect a disproportionate share of funding. Concentrations create a dimension of risk that financial institution management must consider for its risk management policies. For instance, a financial institution with ADC loans concentrated in one location may incur losses from an economic downturn in that area. To help prevent such losses, financial institution management should develop risk management policies that consider this risk and necessary actions to prevent or mitigate losses.

In the event of an economic downturn, institutions with poorly managed concentrations are more vulnerable to financial losses and failure. Such a failure causes losses to the FDIC's Deposit Insurance Fund (DIF)⁵ which provides funds to resolve failed banks and is administered by the FDIC. According to FDIC data, from January 2007 to December 2013, poorly managed concentration risk contributed to (1) CRE and ADC loan losses of \$120.6 billion, (2) the failure of 492 financial institutions, and (3) \$74.6 billion in losses to the DIF.

Nevertheless, the FDIC recognizes that loan portfolio concentration risk is a business reality for many financial institutions and often reflects local trade area borrowing needs and market conditions. According to RMS, although many institutions manage concentration risk, many institutions failed to manage this risk effectively

⁵The DIF is administered by the FDIC and it insures account holder deposits in FDIC insured banks and provides funds to resolve failed banks. Insured banks pay quarterly assessments to fund the DIF.

during the financial crisis.⁶ For institutions with significant loan portfolio concentrations, the resiliency to withstand difficult market conditions depended heavily on the adequacy of their risk management practices and capital levels.

According to a 2015 interagency statement by the federal banking agencies as reflected in an FDIC Financial Institution Letter (FIL), banking industry trends showed increased concentrations and relaxed loan underwriting standards. See FDIC FIL-62-2015, *Statement on Prudent Risk Management for CRE Lending* (December 2015). Figure 1 illustrates total CRE and ADC loan growth by loan product from 2007 through 2017. As depicted, CRE loans peaked prior to the financial crisis before declining. As of December 2017, outstanding debt has exceeded the historical high. Specifically, non-owner occupied CRE⁷ and multi-family loans⁸ have exceeded their historical highs, while ADC loans remain below such levels. As of December 2017, 9 percent (314 of 3,637) and 7 percent (240 of 3,637) of FDIC-supervised financial institutions had a CRE and ADC concentration, respectively.⁹

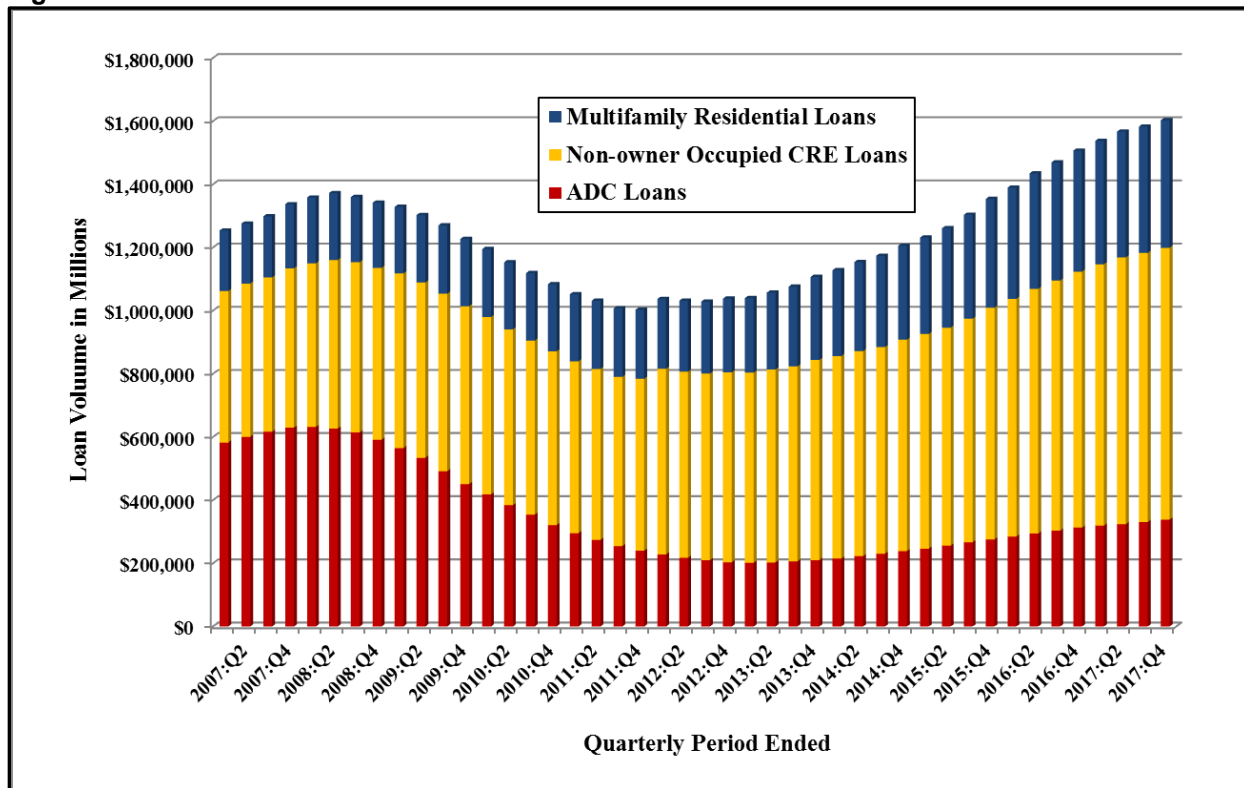
⁶ See RMS Regional Directors Memorandum 2014-008-RMS, *Revised Concentrations Page and Instructions for the Risk Management Report of Examination* (November 2014) (FDIC Revised Concentration Guidance).

⁷ Non-owner occupied CRE loans are secured by other nonfarm nonresidential (commercial) properties that are not owner-occupied.

⁸ Multi-family loans are secured by multifamily (5 or more) residential properties.

⁹ We present concentration threshold criteria later in the section discussing pre-examination planning.

Figure 1: Select CRE and ADC Loan Product Growth



Source: OIG analysis of FDIC’s Consolidated Reports of Condition and Income aggregate data

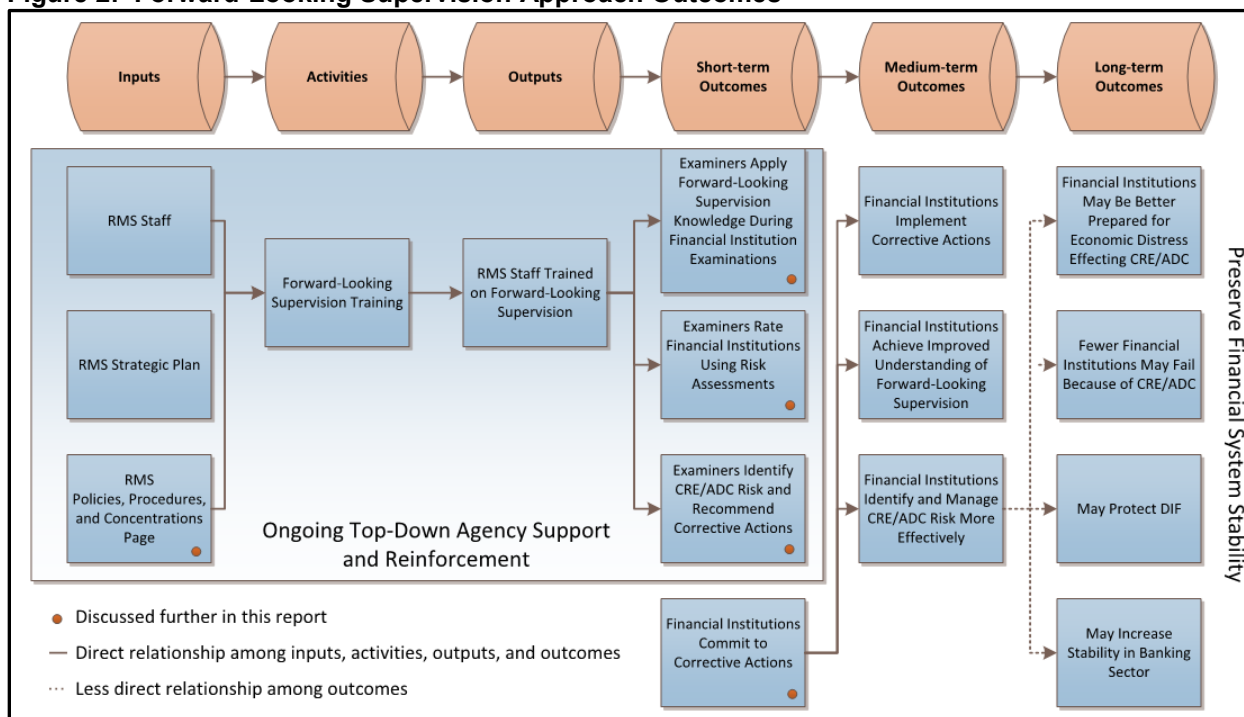
Note: We used key CRE loan product types to illustrate total CRE loans outstanding, excluding unsecured loans to finance CRE. ADC and non-owner occupied loans are generally viewed as riskier due to the reliance on the cash flow from the property as the primary source of loan repayment. In contrast, a borrower’s loan secured by owner-occupied real estate collateral, used in a business, provides the borrower with a secondary source of repayment, thereby making the loan less risky.

These banking industry trends intensify safety and soundness concerns in the event of a significant economic downturn, because such increased market exposure at financial institutions increase the potential risk of loss and failure. Examiners integrate Forward-Looking Supervisory concepts throughout the examination process. The concept of Forward-Looking Supervision includes a broader emphasis on identifying and documenting emerging risks at a financial institution, determining how the elevated risk profiles may adversely affect an institution’s future performance, and recommending appropriate regulatory actions that are commensurate with a financial institution’s condition.

Evaluation Results

In assessing whether the FDIC achieved select Forward-Looking Supervision approach outcomes, we applied the program logic¹⁰ analytical framework and found that the approach is substantially achieving its intended outcomes. Figure 2 depicts the approach and its outcomes, including RMS pursuing supervisory action when it identifies poorly managed risks and the financial institutions implement corrective action. The resulting outcomes occur over time and may contribute to the stability of the financial system.

Figure 2: Forward-Looking Supervision Approach Outcomes



Source: OIG Analysis Applying Program Logic

Our review showed that examiners substantially achieved the short-term outcomes of the Forward-Looking Supervision approach for our sampled institutions. These outcomes, as shown above, include examiners: (1) applying Forward-Looking Supervision concepts during their financial institution examinations, (2) rating institutions based on risk, and (3) recommending corrective actions based on their risk assessments. The outcomes further included financial institution commitments to implement recommended corrective actions.

¹⁰Program logic is an explanatory model, represented graphically, that demonstrates how a program’s activities lead to the expected outcomes and goals. The OIG used program logic during this evaluation to demonstrate RMS’s Forward-Looking Supervision-related activities and their connectedness with the program’s outcomes.

Forward-Looking Supervision may enhance medium-term outcome achievement by financial institutions: (1) implementing corrective actions, (2) achieving improved understanding of the Forward-Looking Supervision approach, and (3) identifying and managing CRE and/or ADC loan concentrations more efficiently.

With respect to long-term outcomes, Forward-Looking Supervision could help the financial institutions be better prepared for economic distress affecting CRE and/or ADC loan portfolios. Better preparation could result in fewer financial institutions failing because of CRE and/or ADC loan losses. Fewer failures may protect the DIF and may increase stability in the banking sector.

We found that the FDIC did not have a comprehensive policy guidance document on Forward-Looking Supervision, and the agency should clarify guidance. Information on Forward-Looking Supervision tended to be diffused throughout FDIC documents. The FDIC should clarify guidance to institutionalize the Forward-Looking Supervision approach, and help to ensure its application regardless of economic conditions and future FDIC management transitions. Clarified guidance would also demonstrate institutional support from high-level FDIC executives and emphasize the importance of the approach throughout the FDIC. Finally, clarified guidance would reinforce the expectations placed upon examiners to conduct Forward-Looking Supervision, document the expectations, and help examiners in their discussions with financial institution management.

Examiners typically documented their overall conclusions regarding the financial institutions' concentration risk management practices. However, we identified instances in which examiners did not always document certain Forward-Looking Supervision concepts consistent with examiner guidance when planning an examination and when reporting examination results. Although examiners were able to explain their actions during our interviews, they did not provide corresponding documentation. Examiners are required to prepare, and document within the Report of Examination, a written analysis. The written analysis should describe the effectiveness of several key categories of the institution's concentration risk management practices. Undocumented analysis creates the risk that examiners may not have sufficiently analyzed financial institution mitigation efforts for asset concentrations. Absent sufficient analysis, examiners may not reach the conclusions necessary to recommend needed corrective actions to the financial institutions. Further, without thorough documentation, supervisory examiners and case managers may find it difficult to assess risk and direct supervisory efforts to mitigate that risk.

Finally, we found that financial institutions responded to examiner concerns and committed to corrective action.

Need for Policy Statement

We found that the FDIC undertook numerous actions over recent years to communicate Forward-Looking Supervisory concepts. However, as described below, FDIC did not have a comprehensive policy guidance document on Forward-Looking Supervision that integrates Forward-Looking Supervision's purpose, goals, roles, and responsibilities. The FDIC should clarify examiner guidance that implements these concepts.

Forward-Looking Supervision is critical to the FDIC's mission to promote stability and public confidence in the nation's financial system through examining and supervising insured financial institutions. Accordingly, RMS established in its 2013-2017 Strategic Plan, a long-term operations objective of reinforcing the importance of Forward-Looking Supervision. To fulfill its operations objective, RMS took actions to reinforce Forward-Looking Supervision, including creating a revised Concentrations page¹¹ and a CRE work program to assist examiners in assessing concentration risk during examinations. RMS also provided training to its examination personnel on Forward-Looking Supervision and conducted reviews to assess compliance by them in implementing Forward-Looking Supervision.

In December 1998, RMS issued a Regional Directors Memorandum that notified examiners of the specific expectations for the processes and outcomes of the risk-focused examination process. See RMS Regional Directors Memorandum, 98-100, *Risk-Focused Examination Process – Program's Goals and Objectives* (December 1998). However, the FDIC's Memorandum did not discuss Forward-Looking Supervision, nor its purpose, goals, roles, and responsibilities. The FDIC has since issued a Regional Directors Memorandum and updated the Risk Management Manual of Examination Policies to reference the concept of Forward-Looking Supervision.

The FDIC should have a written policy guidance document to institutionalize the Forward-Looking Supervision approach and to support achieving the intended impact of FDIC's Strategic Plan operations objective. This policy guidance document would demonstrate institutional support from high-level FDIC executives and emphasize the importance of the approach throughout the FDIC. This policy guidance document would also enhance visibility and awareness of the Forward-Looking Supervision approach within the FDIC and would further acceptance of the approach because of

¹¹FDIC requires bank examiners to complete the revised Concentrations page during their supervisory examinations to document their written analysis on the effectiveness of the institutions' concentration risk management practices. Examiners assess financial institution managements' (1) concentration monitoring and its effectiveness, (2) consideration of economic and competitive conditions, (3) concentration risk profile (product type, collateral type, geographic location), and (4) risk management and control process. Examiners are required to complete the Concentrations page and include it within the Report of Examination when a financial institution has an asset or funding concentration reaching a certain threshold.

its elevated prominence. It would reinforce the expectations placed upon examiners to conduct Forward-Looking Supervision, document the expectations, and support examiners in their discussions with financial institution management. A policy guidance document would also improve the approach's sustainability by firmly establishing it as an approved way of doing business. It would also assist with communication both within the FDIC and externally (i.e., with financial institution management and other FDIC stakeholders) by providing a comprehensive description of the approach to improve understanding. FDIC regional officials and staff also acknowledged that a Forward-Looking Supervision policy guidance document could aid in both educating others and in supporting examiners' discussions of supervisory concerns with financial institution management.

Recommendation

We recommend that the Director, Division of Risk Management Supervision:

- (1) Issue a comprehensive policy guidance document defining Forward-Looking Supervision, including its purpose, goals, roles, and responsibilities.

Forward-Looking Supervision Techniques Applied

A significant challenge to the effectiveness of the FDIC examination process is that examiners may fail to identify and assess a financial institution's elevated risk in a timely manner, and to recommend appropriate corrective action. To enhance timely risk identification, the FDIC issued examination guidance to emphasize Forward-Looking Supervision concepts and enhance examination documentation and communication processes.

Consistent with current examination guidance, examiners typically described Forward-Looking Supervision as delving deeper than

a financial institution's current financial performance. Forward-Looking Supervision techniques also include an examiner's assessment of the financial institution's risk management policies and practices, strategic plans, emerging trends and risks, and consideration of stressed operational environments, such as economic downturns or sharp interest rate movements. Examiners consistently expressed a willingness to downgrade a financial institution's management or asset quality component ratings based solely on risk management concerns—even absent a clear deterioration in

The Goal of Forward-Looking Supervision. According to Regional Directors Memorandum 2016-017-RMS, *Communicating and Coordinating with Institution Management in Carrying out Forward-Looking, Risk-Based Supervision* (December 2016), the goal of Forward-Looking Supervision is to identify and mitigate risk before it impacts the financial condition of a financial institution.

credit quality consistent with the ratings framework.¹² Examiners also stated that their field office supervisors and regional office staff typically supported their assigned ratings.

However, we identified instances in which examiners did not always document certain Forward-Looking Supervision concepts consistent with examiner guidance when planning an examination and when reporting examination results. Undocumented analysis creates the risk that examiners may not have sufficiently analyzed financial institution mitigation efforts for asset concentrations. Absent sufficient analysis, examiners may not reach the conclusions necessary to recommend needed corrective actions to the financial institutions. Further, without thorough documentation, supervisory examiners and case managers may find it difficult to assess risk and direct supervisory efforts to mitigate that risk.

Our testing revealed that examiners typically applied Forward-Looking Supervisory techniques during the examination process, which includes four intermediary phases: (1) planning; (2) scoping; (3) conducting the examination; and (4) drawing conclusions.

Pre-examination Planning and Targeted Loan Review

The examiner's first step toward identifying potential financial institution risk is to conduct a pre-examination review and plan and scope the upcoming examination. This step results in the examiner preparing a Pre-Examination Planning Memorandum (PEP Memorandum).¹³ To assess the examiner's application of Forward-Looking Supervision techniques, we evaluated each PEP Memorandum in our sample. We focused on examiners' identification and discussion of potential concentration and growth risk factors, and their corresponding impact to the planned scope of the examination.

Based on our sampling methodology, all of the financial institutions in our sample had CRE and/or ADC concentrations and experienced significant growth. Specifically, we identified and sampled institutions exposed to significant CRE concentration risk ratios based on either (1) Total ADC loans to Total Capital of 100 percent or more; or (2) Total CRE loans to Total Capital of 300 percent or more accompanied by corresponding ADC or CRE loan growth of 20 percent or more during the prior year. The FDIC uses similar criteria as a preliminary step to identify

¹²Financial institution regulators and examiners use the Uniform Financial Institutions Rating System to evaluate a financial institution's performance in six element areas and ultimately determine an overall composite rating. The six components, represented by the "CAMELS" acronym, include: **C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to market risk.

¹³See Regional Directors Memoranda 2001-036, *Loan Review* (September 2001); 2008-008-RMS, *Revised Pre-Examination Planning Memorandum* (April 2008); 2017-005-RMS, *Commercial Real Estate Work Program* (March 2017).

institutions that may have significant CRE concentration risk and warrant greater supervisory attention.

During pre-examination planning, examiners typically identified the financial institution's CRE and/or ADC loan concentration and significant loan growth:

- 94 percent of PEP Memoranda sampled (51 of 54) identified that the financial institution had a CRE and/or ADC concentration, and
- 83 percent of PEP Memoranda sampled (45 of 54) identified that the financial institution experienced significant loan or asset growth.

However, 17 percent of PEP Memoranda sampled (9 of 54) did not show that significant loan or asset growth had occurred, when in fact, it had. Examiners must document their identification and consideration of potential risk factors, such as significant growth, to ensure an effective FDIC examination.

Scoping

A key focus of Forward-Looking Supervision is on the financial institution's risk management practices. According to examination guidance on formulating a loan review sample, an examiner should consider including newly originated CRE loans when there are existing and developing risk factors related to credit concentrations or significant loan growth. Identifying newly originated CRE loans for review equips examiners to perform a more comprehensive assessment of the financial institution's recent risk management lending practices and underwriting standards.¹⁴ Examiners did not always document how they considered newly originated loans for review. In this regard:

- 83 percent of PEP Memoranda sampled (45 of 54) documented the plan to target newly originated loans within their loan review sample.
- 69 percent of the Reports of Examination sampled (37 of 54) documented that the final loan review sample included newly originated loans in the examination report's Confidential - Supervisory Section page.¹⁵
- 87 percent of sampled documents (47 of 54) either recorded a plan to target newly originated loans and/or recorded that examiners sampled newly originated loans.

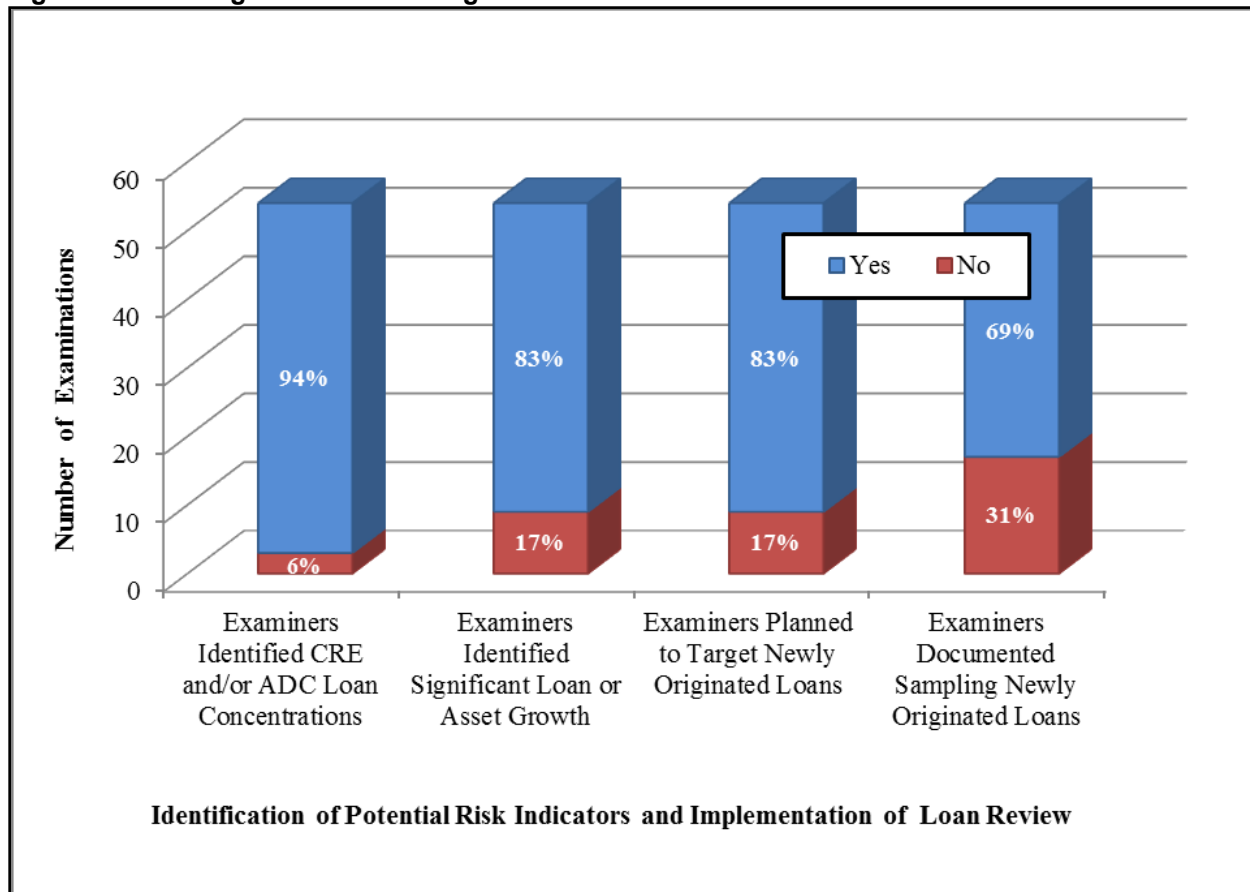
¹⁴Consistent with real estate lending guidelines, CRE lending policies should address the following credit underwriting standards: maximum loan amount by property type; loan terms; pricing structures; collateral valuation; loan-to-value limits by property type; requirements for feasibility studies and sensitivity analysis or stress testing; minimum requirements for initial investment and maintenance of hard equity by the borrower; and minimum standards for borrower net worth, property cash flow, and debt service coverage for the property.

¹⁵The purpose of the report's Confidential - Supervisory Section page is to communicate non-public information to regulatory personnel. The section addresses, in part, the final percentage of loans reviewed, and any significant deviations between the planned and actual examination scope or examination procedures.

- 13 percent of sampled documents (7 of 54) neither recorded a plan to target newly originated loans nor confirmed sampling newly originated loans.

Figure 3 shows that examiners typically identified potential CRE and ADC loan risk indicators and adjusted the scope of their loan review to include such loans.

Figure 3: Planning and Documenting Risk Indicators



Source: OIG analysis of examination reports and PEP Memoranda

The examiners we interviewed stated that they did not always document and discuss sampling newly originated loans in the PEP Memorandum or the examination report's Confidential - Supervisory Section page. However, the examiners told us that they typically included newly originated CRE and/or ADC loans within their loan review sample. Examiners did not provide an explanation for the lack of documentation.

While not explicitly required by examiner guidance, the examination reports we reviewed did not always report on recent trends and changes to the financial institution's CRE and ADC loan underwriting risk management practices. We believe

that such information would have been helpful to facilitate an appropriate supervisory approach for identifying and mitigating risk. In March 2017, RMS issued Regional Directors Memorandum *Commercial Real Estate Work Program*. The Regional Directors Memorandum required, in part, that examiners incorporate an assessment of CRE credit underwriting and administration practices within applicable CRE-related loan concentration write-ups on the Concentrations page.

Conducting Examinations: Analysis of Concentration Risk Management

The FDIC Revised Concentration Guidance requires examiners to analyze and document financial institutions' (1) methodology for identifying and monitoring exposure to specific loan portfolio concentrations, (2) consideration of relevant economic and competitive conditions affecting these concentrations, (3) risk stratification¹⁶ and vulnerability assessment,¹⁷ and (4) risk management and control processes regarding the concentration's current and proposed levels, and stress test results.¹⁸ Prudent business practices suggest that after conducting an analysis, examiners should synthesize the results of their analysis to formulate a conclusion on the financial institution's risk management practice.

When documenting the analysis of a financial institution concentration risk management, examiners did not consistently provide specific conclusions for each category within the report:

- Only 26 percent of the examination reports sampled (14 of 54) included a complete written analysis and provided specific conclusions for each category.
- Conversely, the remaining examination reports sampled (74 percent, 40 of 54) either did not include a complete written analyses or did not provide specific conclusions for each category.¹⁹

We also noted that the examiners' written analyses of complex risk management practices varied widely. In particular, these risk management practices included

¹⁶Risk stratification is the grouping of loans by product type, collateral type, geographic market, internal risk rating, or other relevant factors.

¹⁷This assessment is the review of the concentration's vulnerability to an economic downturn, sharp interest rate movements, or other external market stress events. Portfolio-level and portfolio-segmented stress tests quantify the impact of changing economic conditions on asset quality, earnings, and capital.

¹⁸Risk management and control processes formulate management's operating framework. This framework establishes guidance and monitoring processes such as limits, underwriting standards, and pricing terms; establishes strategic actions to address changing risk profiles, capital adequacy determinations, staffing and managerial needs, pricing actions, etc.; incorporates analytical information (such as stress test results) into policy limits, staffing and managerial resources, capital support, etc.; and reports used by management and the financial institution's board to monitor concentration exposure levels and risk estimates. See FDIC Revised Concentration Guidance, Appendix B.

¹⁹Examiners typically documented their overall conclusions regarding the financial institutions' concentration risk management practices.

concentration stress testing, concentration strategic contingency plans,²⁰ and consideration of the inter-relationship between volatile liability²¹ funding concentrations and asset concentrations.

Supervisory guidance states that the sophistication of an institution's CRE and/or ADC risk management processes should be appropriate to the size of the portfolio, as well as the level and nature of concentrations and the associated risk to the institution. As a result, the FDIC relies significantly on examiner discretion and judgment to determine the sufficiency and adequacy of an institution's risk management practices.

When interviewed, most examiners and case managers stated that they would benefit from case studies²² that illustrate appropriate examiner analysis and written documentation on the more complex risk management practices. Some examiners also noted that they did not realize what "good" concentration stress tests or concentration strategic contingency plans were until they reviewed one at an institution. The distribution of case studies could enhance examiner analysis, examination consistency, examiner judgment, and financial institution communication. For example, a recent bank failure that resulted in a material loss review conducted by the OIG illustrates the importance of adequate training and guidance on Forward-Looking Supervision concepts and techniques.²³

²⁰Concentration Strategic Contingency Plans are the financial institution's planned actions based on changing economic or competitive market risk factors, or a changing institution risk profile.

²¹Volatile liabilities (deposits and borrowings) may be suddenly withdrawn, and the financial institution may have to sell assets at distressed (low) prices or offer higher rates to attract replacement funds. These funds tend to be interest sensitive. Related financial measures include Non-Core Funding Dependence and Short-Term Non-Core Funding Dependence.

²²The FDIC uses financial institution case studies, based upon real-life and hypothetical scenarios to enhance examiner training.

²³FDIC OIG Material Loss Review of First NBC Bank, New Orleans, LA, Report No. AUD 18-002 (November 2017). Section 38(k) of the Federal Deposit Insurance (FDI) Act requires the Inspector General of the appropriate federal banking agency to complete a review and prepare a report when the DIF incurs a material loss with respect to an insured depository institution for which the FDIC is appointed Receiver. For losses that occur after January 1, 2014, the FDI Act defines a material loss as any estimated loss to the DIF in excess of \$50 million. As noted in the FDIC OIG's MLR, the Louisiana Office of Financial Institutions closed First NBC Bank, and appointed the FDIC as Receiver on April 28, 2017. First NBC Bank's total assets at closing were \$4.0 billion, and the estimated loss to the DIF was \$996.9 million.

Recent Bank Failure and the Use of Forward-Looking Supervision. Our OIG Material Loss Review (MLR) of First NBC Bank (New Orleans) reported that:

[T]he FDIC's use of enforcement actions and examination ratings to address First NBC [Bank] issues was counter to the agency's forward-looking supervisory approach. That is, although examiners identified repeated risk management weaknesses, they relied too heavily on the bank's financial condition and ability to raise capital in taking supervisory action and assigning management and asset quality ratings.

Examiners identified risk management concerns involving financial institution management (dominant individual) and asset quality (loan underwriting, problem loan identification, and aggressive growth). However, the financial institution did not mitigate the risks in a timely manner. Capital contributions forestalled supervisory concern, until there was a clear and obvious financial decline, which is contrary to the principle of Forward-Looking Supervision.

The FDIC agreed that it should have set a strong supervisory tone by pursuing stronger enforcement actions earlier, and that supervisory efforts by FDIC to address board oversight and risk management weaknesses should have been stronger, in line with the FDIC's principles of Forward-Looking Supervision. RMS also noted that in the years preceding the institution's failure, the FDIC's recommendations were not sufficiently strong to cause First NBC Bank's board and management to take adequate or consistent actions to address the root causes of the identified concerns or maintain a control environment commensurate with the growth, size, and complexity of its operations.

In our evaluation interviews, examiners, case managers, and supervisory personnel attributed documentary deficiencies to a learning curve in implementation of the FDIC Revised Concentration Guidance. These officials explained that during 2016 and 2017, the FDIC undertook additional actions to reinforce and enhance examiner analysis and documentation of a financial institution's CRE and/or ADC concentration risk management practices, including training on Forward-Looking Supervision and the FDIC Revised Concentration Guidance, and issuing examination guidance on developing and supporting examination report analysis-specific to concentration risk management.

Drawing upon lessons learned from the recent financial crisis of 2008-2011, the FDIC continues to strengthen the examination program and enhance Forward-Looking, risk-focused supervision. In addition, the FDIC New York and Chicago regional offices conducted internal reviews on the implementation of the FDIC Revised Concentration Guidance and identified similar concerns to those described in this report. For example, the New York regional review concluded that:

Certain written comments included a broad assessment of management's measurement and monitoring systems and focused on recommendations for improvement/enhancement. As such, in these

instances, comments generally lacked sufficient detail to thoroughly discuss and assess the items enumerated in [FDIC Revised Concentration Guidance].

Similarly, the Chicago regional review found that:

[S]ix of the Reports sampled identified a concentration during the examination; however, the comments and calculations included within these six reports did not follow the guidance established in [FDIC Revised Concentration Guidance]. Many of the exceptions were due to the written analysis of the concentration not describing the effectiveness of the institution's risk management practices as captured in the categories of identification, economic and competitive factors, risk stratification and vulnerability assessment, and risk management and control processes.

As a result, these regions further fortified their attention to the applicable guidance by reinforcing the examination compliance and supervisory review process. In addition, the New York region shared additional examples of well-written comments to its examination staff.

Without documentary evidence supporting examiners' written analyses, deficiencies in financial institution concentration risk management may go undetected. The absence of written analysis limits the case manager's ability to understand the financial institution's concentration risk management practices, and to review and assess the depth and quality of the examiner's analysis. This limitation could prevent the FDIC from achieving the Forward-Looking Supervision approach desired outcomes of identifying and mitigating risk management weaknesses before they impact the financial condition of an institution.

Recommendations

We recommend that the Director, Division of Risk Management Supervision:

- (2) Issue guidance to reinforce how and where examiners should be documenting concentrations and an institution's concentration risk management practices in the report of examination,
- (3) Provide additional case studies on Forward-Looking Supervision to strengthen training for examiners on the analysis and identification of potential financial institution risk management weaknesses, and

- (4) Conduct recurring retrospective reviews to validate that examiners thoroughly documented their written analyses of the financial institutions' practices regarding concentration risk management.

Concluding Examinations: Assigning Financial Institution Ratings and Corrective Actions

The examiner's last step in assessing and addressing identified financial institution risk is to assign ratings and consider requiring informal and formal enforcement actions. To assess the examiner's application of Forward-Looking Supervision techniques, we reviewed the examiners' assigned Asset quality, Management, and composite ratings, as well as the examiners' use of corrective actions and corresponding provisions²⁴ to address identified concentration risk management concerns.

Assignment of Ratings. The examiners' assigned Asset quality, Management, and composite ratings appeared to be consistent with their written comments and conclusions. In accordance with examination guidance, the Asset quality component ratings appropriately reflected the quantity of existing and potential credit risk associated with the loan portfolio, and the ability of management to identify, measure, monitor, and control credit risk, including the existence of asset concentrations. The Management component ratings appropriately reflected the capability of the board of directors and management to identify, measure, monitor, and control the risks prompted by an institution's activities, including credit risk.²⁵ The composite ratings appeared to reflect an evaluation of an institution's managerial, operational, financial, and compliance performance.

CAMELS Ratings. In accordance with the Uniform Financial Institutions Rating System, when assigning ratings, examiners consider an institution's size and sophistication, the nature and complexity of its activities, and its general risk profile. Each component rating reflects a qualitative analysis of the factors relating to that component and its interrelationship with other components. A financial institution's composite rating generally bears a close relationship to its component ratings. However, when assigning a composite rating, some components may be given more weight than others depending on the facts and circumstances at an institution.

²⁴Provisions are specific corrective measures an institution or individual respondent is required to take under a corrective action.

²⁵Credit risk is the risk that a borrower will not pay a loan as called for in the original loan agreement and may default on the obligation. Credit risk is one of the primary risks in bank lending.

Consideration of Informal and Formal Enforcement Actions. We found that the examiners' initiation of or reliance on outstanding informal or formal enforcement actions followed applicable guidance. Eleven financial institutions in our sample had outstanding informal or formal enforcement actions. Ten of these actions included provisions to address identified concentration risk management concerns.

However, for one financial institution, the enforcement action lacked a concentration risk management provision. The examiner stated that he considered updating the outstanding MOU,²⁶ but was uncertain what provision to recommend. The regional office case manager, responsible for finalizing the report and pursuing further corrective action, stated that she determined that recommending corrective action within the Matters Requiring Board Attention (MRBA) page²⁷ of the report presented the most appropriate supervisory response due to their immediate effect.²⁸ MRBAs require supervisory follow up in the months following issuance of the examination report.

Informal and Formal Enforcement Actions. Regulatory agencies may use informal and formal procedures to address weak operating practices, deteriorating financial conditions, or apparent violations of laws or regulations. Examiners should consider an informal action for all institutions rated "3" (less than satisfactory), and examiners should consider recommending formal enforcement action for institutions rated "3" if management appears unwilling to take appropriate corrective measures, and for all composite 4- or 5-rated institutions.

Elevating Concerns within Examination Reports

Communication is a critical tool to successful Forward-Looking, risk-focused supervision. Examination reports are one vehicle that the FDIC uses to communicate concentration risk management analysis, conclusions, and concerns. Examiners document their written analysis of a financial institution's concentration risk management in the examination report's Concentrations page. Depending on the significance of their concerns, examiners may elevate their conclusions and concerns to the front of the report. This is important because elevating concerns and

²⁶A Memorandum of Understanding (MOU) is a common informal agreement used by the FDIC to obtain a commitment from a financial institution's board of directors to implement specific corrective measures. Other informal actions include bank board resolutions, letter agreements, and other forms of bilateral agreements or unilateral actions by the financial institution on their own initiative.

²⁷An MRBA is an issue or risk of significant importance that requires more effort to address and board and senior management attention. MRBAs are one example of supervisory recommendations, which the FDIC uses to inform the institution of the FDIC's views about changes needed in its practices, operations, or financial condition. This supervisory recommendation helps directors prioritize their efforts to address examiner concerns, identify emerging problems, and correct deficiencies before the bank's condition deteriorates (or to keep the bank viable if conditions already deteriorated). An institution that addresses supervisory recommendations may avoid formal enforcement actions.

²⁸The examiner assigned this financial institution a 2-rating (i.e., satisfactory) on Asset quality. Although subject to examiner discretion, elevating a concentration risk management recommendation to the report's MRBA page and updating an outstanding informal action to include a concentration risk management provision are not mutually exclusive.

recommendations provides greater visibility and awareness to the financial institution's board of directors and senior management.

Our review found that examiners typically elevated concentration risk management concerns in the examination report. However, we noted limited use of the MRBA page to communicate concerns to the financial institutions' board of directors in the Reports of Examination.

FDIC guidance requires examiners to document their written analysis of a financial institution's concentration risk management on the Concentrations page. Further, the examiners should bring forward their assessment of the institution's concentration risk management to various (more prominent) report sections, including the Risk Management Assessment (RMA),²⁹ Examination Conclusions and Comments (ECC),³⁰ and MRBA, when warranted. The placement of the assessment comments and supervisory recommendations³¹ depends on the degree of supervisory concern. Supervisory recommendations should be elevated from the RMA and ECC pages to the MRBA page when examiners identify an important issue or risk that requires significant effort to address, thus requiring the attention of the financial institution's board and senior management.³²

To assess the examiner's elevation of concentration risk management conclusions, concerns, and recommendations within the examination report, we reviewed each report for examiner commentary. Within our sampled population, we identified 41 out of 54 examinations (76 percent) that reported concentration risk management concerns and recommendations. For these examinations, we tracked the placement and elevation of concentration risk management conclusions, concerns, and recommendations through the report.

We found that examiners typically reported or elevated identified overall concentration risk management conclusions and concerns into the report's Concentrations, RMA, ECC, or MRBA pages. In some instances, examiners discussed concerns within multiple sections of the report. In other cases, discussion was limited to only one section of the report. We observed the following:

²⁹The RMA page is used to highlight deficiencies in risk management policies, procedures, and practices and to provide recommendations for corrective action, ideally before risk management practices impact the institution's condition. When appropriate, the examiners overall concentration risk management assessment and recommendations should be presented on the RMA page. If the RMA page is not included in the Report of Examination, the assessments should be included on the ECC page.

³⁰The ECC page is the primary report section examiners use to summarize examination findings, inform directors and senior management of undue risks, and guide corrective actions through presentation of supervisory recommendations when appropriate.

³¹Supervisory recommendations include recommendations communicated on the ECC page and recommendations communicated on other report pages, such as the RMA page.

³²Where possible and when applicable, examiners are encouraged to bring significant risk management deficiencies to the institution's board even if those deficiencies are not yet reflected in the institution's financial condition and performance ratios. Examples of MRBA that could warrant highlighting include: emerging issues, policy weaknesses, ineffective management, repeat examination recommendations, enforcement action provisions requiring continued attention, and significant regulatory noncompliance.

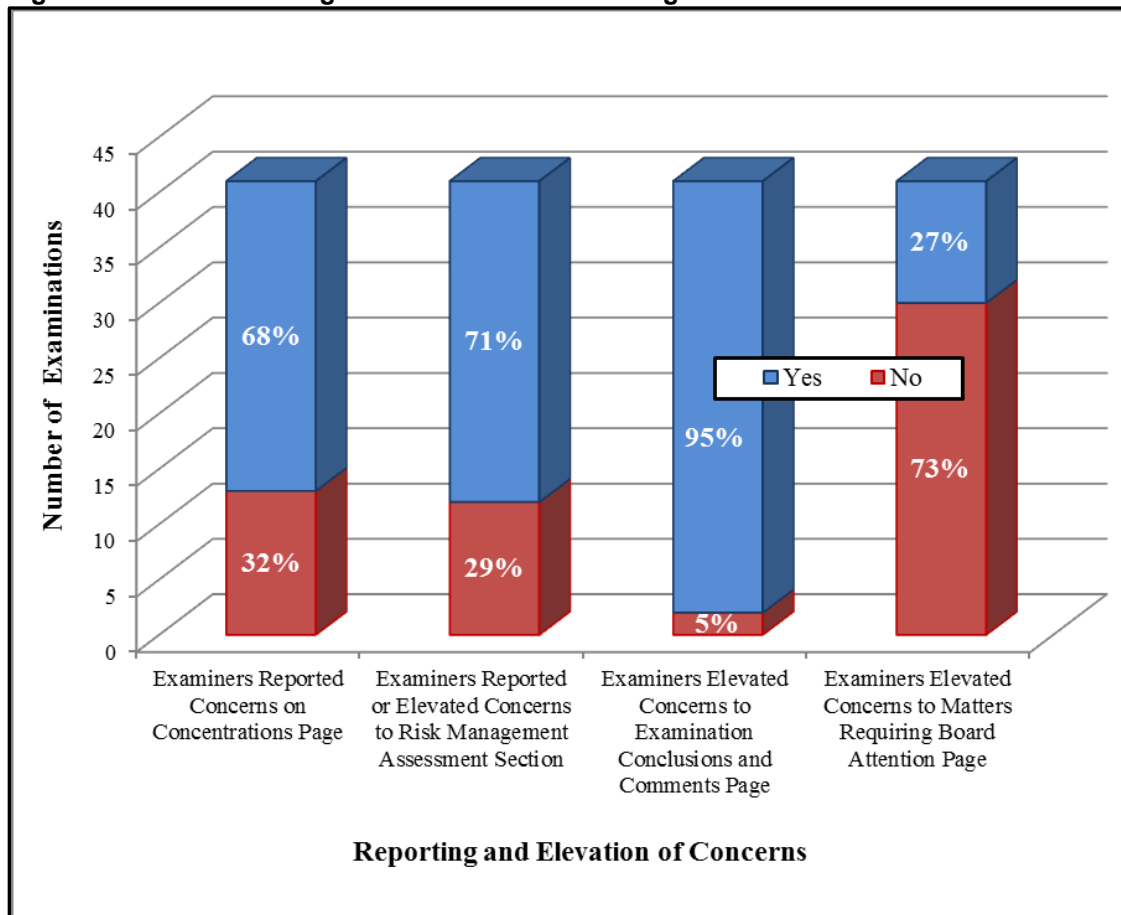
- 68 percent of Reports of Examination sampled (28 of 41) used the Concentrations page to present concentration risk management concerns;
- 71 percent of Reports of Examination sampled (29 of 41) used the RMA page either to present or elevate concentration risk management concerns.
- Ten reports (24 percent) did not include the RMA page. The RMA page is optional and subject to examiner discretion. When interviewed, examiners and regional supervisory personnel stated that certain Assistant Regional Directors did not require examiners to use the RMA page due to its redundancy with the ECC page.
- 95 percent of Reports of Examination sampled (39 of 41) used the ECC page to elevate concentration risk management concerns. In the two exceptions, the reports identified and discussed concentration risk management concerns on the Concentrations page only, without further elevation within the examination report.
- 27 percent of Reports of Examination sampled (11 of 41) used the MRBA page to elevate concentration risk management concerns and recommendations. Of these institutions, approximately half (46 percent, 5 of 11) were assigned a less than satisfactory composite rating³³ and subject to heightened communication and supervisory oversight through an informal or formal corrective action.

Conversely, when examiners assigned a satisfactory composite rating of 2, they tended not to elevate concentration risk management concerns to the MRBA page – despite the presence of potentially emerging issues or weaknesses that, if left unaddressed, could increase the institution’s risk profile. As previously noted, the MRBA page is intended to provide targeted communication to the institution’s board and senior management on issues involving risks of significant importance. Forward-Looking Supervision is more effective when examiners communicate areas of concern early, before a financial institution experiences significant financial decline. When interviewed, examiners stated that they did not elevate identified concentration risk management concerns to the MRBA page, because the examiners believed that the institutions could address examiner concerns and corresponding recommendations in the normal course of business. However, due to these financial institutions’ concentration positions, recent loan growth, and identified concentration risk management concerns, FDIC guidance suggests that there should be a higher percentage of examination reports that used the MRBA page.

Figure 4 shows that examiners typically communicated and elevated concentration risk management concerns within the Reports of Examination.

³³Financial institutions assigned a composite rating of 3, 4, or 5 are considered to be rated less than satisfactory.

Figure 4: Communicating Concentration Risk Management Concerns



Source: OIG analysis of examination reports

We identified three actions of examiners that, when consistently implemented, enhance the Forward-Looking Supervision approach and communication with financial institutions: (1) using the Concentrations page first to report their concentration risk management analysis, concerns, and conclusions; (2) elevating their overall conclusions, and significant concerns and recommendations throughout the report; and (3) using the MRBA page to communicate concerns earlier to the financial institution’s board of directors on emerging issues or concentration risk management weaknesses. With enhanced communications, financial institutions can understand and accept examiners’ conclusions and recommendations, and implement corrective action on a timely basis. RMS recently enhanced communication efforts by issuing a Regional Directors Memorandum. In June 2017, RMS issued a Regional Directors Memorandum that reinforces established supervisory principles in communicating examination report recommendations, including when examiners determine that MRBA are necessary. See RMS Regional Directors Memorandum, 2017-012-RMS, *Supervisory Recommendations, including Matters Requiring Board Attention* (June 2017).

Identification of Concentration Concerns in Timely Manner

One outcome of the Forward-Looking Supervision approach is timely identification of risk and recommendations for corrective action. We found that examiners generally identified concentration risk management concerns on a timely basis. However, we noted five instances (15 percent) in which examiners identified fundamental concentration risk management concerns at an examination that had not been identified during a prior examination cycle.³⁴ These delays can hinder the financial institution's ability to implement corrective actions in a stressed financial condition or operational environment.

To assess the examiners' timely identification of concentration risk management concerns, we reviewed prior examination cycle loan portfolio structures for our sampled financial institutions to identify those institutions that had a CRE and/or ADC loan concentration during their prior examination (33 out of 54 financial institutions). For such institutions, we compared the prior and current examination results to assess the identification of concentration risk management concerns. In addition, for our original sample of 54 examinations, we evaluated each sampled Concentrations page for completion and written analysis.

Previous and Current Concentration Risk Management Concerns

Based on our review, examiners generally identified concentration risk management concerns on a timely basis. We observed the following:

- 79 percent of examiners in our sample (26 of 33) identified concentration risk management concerns on a timely basis during the prior examination. In this group, the volume and detail of concerns included in the current examination reports increased as compared to the concerns identified in the prior examination.

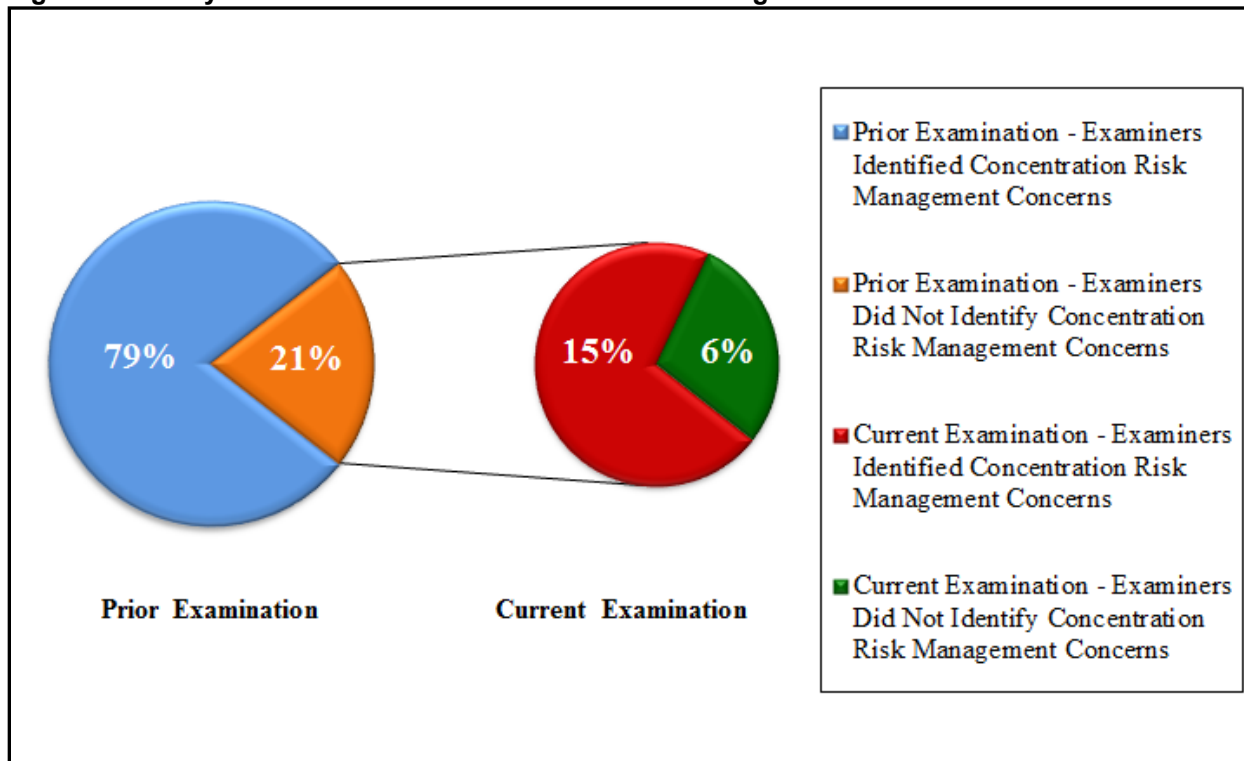
Intent of FDIC Supervision. The FDIC conducts examinations to ensure public confidence in the banking system and to protect the FDIC's DIF. On-site examinations help ensure the stability of insured depository institutions and enable the FDIC to identify undue risks and weak risk management practices. The accurate identification of existing and emerging risks helps the FDIC develop effective corrective measures for individual institutions and broader supervisory strategies for the industry.

³⁴FDIC typically conducts full-scope, on-site examinations at least once during each 12-month period. However, annual examination intervals may be extended to 18-months under certain conditions (e.g., total assets less than \$1 billion, well capitalized institution, composite ratings of 1 or 2, management ratings of 1 or 2 and no change in control).

- 15 percent of examiners in our sample (5 of 33) did not identify any concentration risk management concerns during the examination prior to the current one we reviewed. These institutions had ADC and/or CRE concentrations above the threshold requiring examiners to provide a written analysis. In three of the five examinations, examiners did not document any written analysis that touched upon the four concentration risk management categories on the Concentrations page. In the two remaining examinations, examiners completed a written analysis and reported no concerns. However, during the current examination, examiners identified concerns and required further enhancement or improvement to each of the five financial institution's concentration risk management practices. For example, examiners recommended that financial institutions improve: (1) establishment of concentration limits, stress testing, and contingency plans; and (2) concentration risk identification, measurement, monitoring, reporting, and control. Although examination ratings varied, these financial institutions were also subject to at least an Asset quality and/or Management component rating downgrade, or the retention of a less than satisfactory composite rating.
- For the remaining subset in this sample, 6 percent of examiners (2 of 33) did not identify concentration risk management concerns during either the prior or current examinations. For these examinations, although report commentary and analysis appeared limited, examiners favorably concluded on the institutions' concentration risk management practices for two consecutive examinations. In addition, the assigned component and composite ratings remained the same. The examiners' consecutive conclusions suggest that the financial institutions exercised adequate concentration risk management.

Figure 5 shows that examiners generally identified concentration risk management concerns on a timely basis, between two consecutive Reports of Examination.

Figure 5: Timely Identification of Concentration Risk Management Concerns



Source: OIG analysis of examination reports

Completion of the Concentrations Page and Written Analysis

Based on our review, we noted that 15 percent of examiners in our sample (8 of 54) either did not include the Concentrations page because of an intermittent change in the financial institutions’ concentration position, or simply did not provide a written analysis within the Concentrations page. Among those that did not provide a written analysis within the Concentrations page, most examiners (75 percent, 6 of 8) discussed some concentration risk management elements and related concerns elsewhere in the examination report. However, examiners not using and completing the Concentrations page limits the informational value of the examination report for bank management and could delay appropriate corrective action to mitigate risk.

As discussed earlier, the absence of clear and complete written analyses creates the risk that examiners did not perform the proper analysis, did not effectively communicate concentration risk management analysis and conclusions, and did not identify concentration risk management concerns and weaknesses on a timely basis. Examiners, case managers, and supervisory personnel that we interviewed stated that there was a learning curve associated with completing the Concentrations page, but that examiners now document their analysis more fully. In addition, these

officials noted that the FDIC's recent training, guidance, and supervisory emphasis on Forward-Looking Supervision and concentration risk management reinforce and enhance examiner analysis and identification of potential concerns.

Financial Institutions Respond to Examiner Recommendations

Another outcome of the Forward-Looking Supervision approach is for a financial institution to mitigate risk before it materially impacts the institution's financial condition. We found that when FDIC expressed a concern and recommended a concentration risk management practice, financial institutions typically committed to undertake corrective action. However, financial institutions with a less than satisfactory composite rating typically took an extended period of time to implement comprehensive corrective action. Ultimately, delayed or improperly implemented risk mitigation efforts decrease the impact and effectiveness of the Forward-Looking Supervision approach. This increases the risk that a financial institution may incur greater financial loss in a stressed financial condition or operational environment.

To assess financial institutions' responsiveness to supervisory recommendations, we reviewed each examination report identifying examiner concentration risk management concerns and recommendations. From our sample, we identified 41 out of 54 examinations (76 percent) that reported such concerns. For this subset, we reviewed institution management's reported response to supervisory concerns. We then interviewed RMS supervisory personnel to obtain their perspective on the challenges that both the FDIC and financial institutions face in ensuring that financial institutions effectively implement and maintain corrective measures. Finally, for financial institutions assigned a less than satisfactory composite rating, we analyzed their historical and subsequent responsiveness to supervisory recommendations.

Financial Institution Management. According to the *Risk Management Supervision Manual of Examination Policies*, the quality of management is probably the single most important element in the successful operation of a financial institution. In the complex, competitive, and rapidly changing banking environment, it is important for all members of bank management to be aware of their responsibilities and to discharge those responsibilities in a manner which will ensure the institution's stability and soundness. Bank directors and executive officers are ultimately responsible for their institution's safe and sound operation. The FDIC rates the capability of the board of directors and management, in part, based upon their responsiveness to auditor and supervisory recommendations.

Financial Institutions Commit to Corrective Action

Financial institutions typically responded to examiners' concerns and committed to take corrective action. Based on our review, all financial institutions (100 percent, 41 of 41) committed to take action, or implemented corrective action during the examination process.

However, RMS officials whom we interviewed noted that financial institutions – even when committed to take action -- may face potential hurdles to implement corrective action effectively. [Appendix 4](#) of this report presents additional details on what RMS officials believed to be the potential hurdles that financial institutions may face.

Financial institutions experiencing significant financial decline may endure challenges in implementing effective corrective action because they are reacting to deteriorating or deficient performance, and/or unsafe and unsound conditions. The FDIC considers Forward-Looking Supervision as a means to prevent or mitigate serious problems in an institution, by identifying and correcting such problems or conditions at an early phase.

From our sample, we identified 11 out of 54 financial institutions (20 percent) that received a less than satisfactory rating. Nearly three quarters of this group (73 percent, 8 of 11) did not implement comprehensive corrective action within one year. The issues and regulatory concerns for these institutions stem from long-standing problems that existed prior to RMS's Forward-Looking Supervision initiative in 2011. RMS senior management asserted that certain corrective actions, like obtaining additional capital when an institution is in a troubled³⁵ state, take longer to achieve than implementing an appropriate concentration risk management practice.

³⁵ Financial institutions assigned a composite rating of 4 or 5 are considered to be troubled financial institutions.

FDIC Comments and OIG Evaluation

The Director, RMS, provided a written response, dated July 30, 2018, to a draft of this report. The response is presented in its entirety in [Appendix 5](#). The Director concurred with all four of the report's recommendations. The Director stated that RMS plans to complete actions to address the recommendations by March 31, 2019.

In subsequent communication regarding recommendation 4, RMS advised us that, since June 2016, RMS has performed regional reviews in San Francisco, Kansas City, and Atlanta. In addition, a review of the Dallas Region is ongoing and RMS expects to complete it in March 2019. RMS confirmed that these reviews include procedures to validate that examiners are documenting their analyses of financial institutions' concentration risk management practices. The OIG intends to perform follow-up work at the completion of the Dallas Region review to evaluate RMS's methodology and results.

All four recommendations will remain open until we confirm that corrective actions have been completed and are responsive. [Appendix 6](#) contains a summary of the FDIC's corrective actions.

Objective, Scope, and Methodology

Our evaluation objective was to determine whether the Forward-Looking Supervision approach achieved its outcomes—the Division of Risk Management Supervision pursued supervisory action upon identifying risks and the financial institutions implemented corrective measures.

We conducted this performance evaluation from May 2017 to October 2017 in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation*.

The scope of this evaluation included reviewing select FDIC Reports of Examination, (December 2015 to June 2016), to assess the analysis performed, conclusions reached, and actions taken by examiners during their risk management examinations. Our evaluation studied institutions with CRE and ADC loan concentrations that had recently experienced high loan growth. We sought to determine the extent to which examiners identified concerns with the institution's loan concentration risk management practices and what actions the examiners pursued. Focusing on these cases enabled us to gauge the FDIC's implementation of Forward-Looking Supervision and assess its contribution in achieving intended outcomes. As of December 2015, financial institutions with a CRE loan concentration represented 7.7 percent of the FDIC's total supervised financial institutions. Those with an ADC concentration represented 5.4 percent.

To achieve the evaluation objective, we performed the following procedures and techniques:

- Researched applicable criteria such as relevant regulations, Statements of Policy, Financial Institution Letters, Regional Directors Memoranda, and Examination Documentation modules. Based on this research, we identified key examination guidance that corresponded to Forward-Looking Supervision and CRE and ADC concentration risk management concepts, and developed a data collection instrument³⁶ for assessing key provisions in the guidance. Our data collection instrument largely focused on the implementation of the FDIC Revised Concentration Guidance.

³⁶A Data Collection Instrument is a tool to facilitate the data collection process of gathering and measuring information on targeted variables in an established systematic fashion, which then enables one to answer relevant questions and evaluate outcomes.

- Considered other regulatory agencies and the U.S. Government Accountability Office work, the FDIC's 2016 Annual Report and Assurance Statement, and the FDIC performance goals from 2010 to 2017.
- Implemented a multistage non-statistical sampling process using the December 2015 universe of all FDIC-supervised financial institutions as our pool. We first identified financial institutions subject to review based on certain CRE and/or ADC concentration and growth risk metrics, and then identified and sampled examinations completed from December 2015 to June 2016. This captured recent examinations and enabled us to assess the use of Forward-Looking Supervision in the examination process. We selected examinations to ensure institution diversity based on composite rating, total asset size, and regional location. We selected 54 examinations for our sample.
- Reviewed sampled examination documentation for the examiners' pre-examination planning analysis and targeted loan review plans, implementation of Forward-Looking Supervision examination strategies and analysis, and communication of identified concentration risk management concerns, using our data collection instrument. We also reviewed the financial institutions' subsequent response to identified concentration risk management concerns. Our testing considered PEP Memoranda, examination reports, Summary Analysis Examination Reports,³⁷ follow-up correspondence, subsequent actions, and financial institution progress reports.
- Interviewed selected examiners, field office supervisory personnel, and regional office and headquarters personnel for their understanding, implementation, and perspective on the Forward-Looking Supervision approach. We designed our testing methodology, data collection, and interviews to answer the following questions:
 - How do examiners interpret and implement Forward-Looking Supervision concepts for financial institutions that have experienced high growth and high CRE and ADC concentration risk?
 - Are examiners assessing risk management practices for financial institutions that have experienced high growth and high CRE and ADC concentration risk?
 - What risk management concerns are being identified?

³⁷The Summary Analysis of Examination Report provides a historical record of an institution, and case manager comments briefly summarizing the examination findings.

- What actions did examiners take to communicate identified risk management concerns to financial institution management?
 - Based on the concerns identified, do the examiners' actions appear reasonable?
 - Are examiners identifying CRE and ADC concentration concerns on a timely basis?
 - Have examiners accepted Forward-Looking Supervision strategies into the examination process?
 - Are financial institutions taking action to address identified concentration risk management concerns?
- Analyzed collected data on an aggregate and segmented basis, and analyzed and determined the impact of potentially mitigating factors, based on clarifying interview statements. Segmented data analysis considered the financial institution's total asset size, FDIC's supervisory region, and assigned ratings.

Our methodology relied on information we collected from FDIC's on-line resources. We did not contact the financial institutions as part of this evaluation.

Term	Definition
Acquisition, Development, and Construction Loan	Loans originated for (1) 1-4 family residential construction, (2) other construction, (3) land development, or (4) all other land loans.
Commercial Real Estate Loan	Loans originated for (1) acquisition, development, and construction; (2) multifamily (5 or more) residential properties; (3) non-owner occupied nonfarm nonresidential (commercial) properties; or (4) CRE, construction, and land development activities not secured by real estate.
Concentration	A significantly large volume of economically related assets that an institution has advanced or committed to a certain industry, person, entity, or affiliated group. These assets may, in the aggregate, present a substantial risk to the safety and soundness of the institution.
Concentration Risk	The added dimension of risk that compounds the risk inherent in individual loans due to concentrations of credit exposures. CRE concentrations may make institutions more vulnerable to cyclical CRE markets.
Financial Institution Letters	FDIC communications addressed to FDIC-supervised institutions' Chief Executive Officers. These letters may announce new regulations and policies, new FDIC publications, and a variety of other matters of principal interest to those responsible for operating a bank or savings association.
Program	Activities implemented to achieve a goal.
Program Logic	An explanatory model that demonstrates how a program's activities lead to the expected outcomes and goals represented graphically.
Result	The output and outcome of a program or approach.
Risk	The uncertainty that an organization will not achieve its objectives due to internal and external factors and influences.
Risk-focused Supervision	The risk-focused examination process attempts to assess an institution's risk by evaluating its processes to identify, measure, monitor, and control risk. The risk-focused examination process seeks to strike an appropriate balance between evaluating the condition of an institution at a certain point in time and evaluating the soundness of the institution's processes for managing risk.

Glossary

Term	Definition
Tier 1 (Core) Capital	<p>Defined in Part 325 of the FDIC Rules and Regulations, 12 Code of Federal Regulations, section 325.2(v), as:</p> <p>The sum of:</p> <ul style="list-style-type: none">▪ Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values);▪ Non-cumulative perpetual preferred stock; and▪ Minority interest in consolidated subsidiaries; <p>Minus:</p> <ul style="list-style-type: none">▪ Certain intangible assets;▪ Identified losses;▪ Investments in securities subsidiaries subject to section 337.4; and▪ Deferred tax assets in excess of the limit set forth in section 325.5(g).
Tier 2 Capital	Tier 2 Capital includes the allowance for loan and lease losses up to 1.25 percent of risk-weighted assets, qualifying preferred stock, subordinated debt, and qualifying tier 2 minority interests, less any deductions in the tier 2 instruments of an unconsolidated financial institution.
Total Capital	For purposes of this evaluation, the term "Total Capital" means Total Risk-Based Capital. Total Risk-Based Capital is the sum of <u>Tier 1 Capital</u> and <u>Tier 2 Capital</u> .

ADC	Acquisition, Development, and Construction
CAMELS	C apital Adequacy, A sset Quality, M anagement Practices, E arnings Performance, L iquidity Position, and S ensitivity to Market Risk
CRE	Commercial Real Estate
DIF	Deposit Insurance Fund
ECC	Examination Conclusions and Comments
FDI	Federal Deposit Insurance
FDIC	Federal Deposit Insurance Corporation
FIL	Financial Institution Letter
GAO	Government Accountability Office
MLR	Material Loss Review
MOU	Memorandum of Understanding
MRBA	Matters Requiring Board Attention
OIG	Office of Inspector General
PEP Memorandum	Pre-Examination Planning Memorandum
RMA	Risk Management Assessment
RMS	Division of Risk Management Supervision

FDIC's examination personnel offered the following potential obstacles that may delay or prevent corrective action:

- Financial institution management may be reluctant to accept or implement corrective action. If management views a recommended practice as mere “paperwork” to appease the regulators, then the effectiveness of the new internal controls could be diminished. Examiners also noted that obtaining management acceptance is easier when the economy or the institution's financial condition is deteriorating, as compared to when the financial institution is growing and profitable. RMS officials noted that financial institution management has been more accepting of regulatory recommendations since emerging from the last financial crisis.
- Financial institutions may have limited resources and competing priorities that delay implementation of examination recommendations. Some financial institutions may not have the financial resources or expertise to develop and effectively implement more complex risk management practices or processes that adequately measure, monitor, and control risk.
- Financial institution management may not understand FDIC's concerns and the corrective action needed. As discussed earlier, we recommended that RMS reinforce the Concentrations page use. Examiner's use of the Concentrations page to document concentration risk management written analysis may further enhance financial institution understanding of FDIC's concerns and the corrective action needed. A written analysis will enhance the informational value of the examination report, as it will provide greater transparency and understanding of the examiner's assessment of an institution's risk management processes for identifying, managing, monitoring, and controlling concentration risk.
- Financial institutions may receive or perceive a mixed message from the regulatory agencies. Regulatory agencies³⁸ or examination teams may have differing expectations, and interpret supervisory guidance and prior examination recommendations differently. As discussed earlier, we recommended that RMS issue revised guidance, reinforce the Concentrations page use, and provide additional case studies to strengthen

³⁸Under the FDI Act, the FDIC and state regulators may share responsibility for onsite reviews. 12 U.S.C. § 1820(d). Section 337.12 of the FDIC Rules and Regulations implements these provisions of the FDI Act and governs the frequency of examinations for insured state nonmember banks. 12 C.F.R. § 337.12 (2017).

examiner training. In addition, we recognized that the FDIC recently issued guidance that incorporated a CRE Work Program. These actions may improve the consistency of examiner and regulatory agencies understanding and implementation of Forward-Looking Supervision concepts and analysis. Additional guidance and a work program (which are made available to other regulatory agencies) will enhance understanding and consistency between examiners and other regulatory agencies – thus, reducing potential mixed messages.

- Subsequent examinations may not sufficiently pursue prior examination concerns and recommendations, ultimately delaying effective corrective action. As discussed earlier, we recommended that RMS issue revised guidance, and reinforce the Concentrations page use. In addition, we recognized that the FDIC recently reinforced MRBA guidance. These actions may improve the examiner’s understanding and implementation of their role and responsibilities, and subsequent review of prior examination recommendations. The MRBA page will capture supervisory recommendations and initiate a formal tracking process that collects and reviews financial institution management’s actions in response to these items during the post examination period.
- FDIC guidance may be unclear and lack specific required practices. As discussed earlier, we recommended that RMS issue revised guidance, reinforce the Concentrations page use, and provide additional case studies to strengthen examiner training. In addition, we recognized that the FDIC relies significantly on examiner discretion and judgment to determine the sufficiency and adequacy of an institution’s risk management practices. These actions may improve the FDIC’s internal and external communication and discussion with financial institutions on Forward-Looking Supervision concepts; and, the FDIC’s employment of examiner analysis, discretion, and judgment. Ultimately, the financial institution’s board of directors is responsible for the formulation of sound policies and objectives of the bank, effective supervision of its affairs, and promotion of its welfare. When formulating guidance, the FDIC recognizes that all institutions should properly manage their risks. However, appropriate management practices vary considerably among financial institutions depending on their size, complexity, and risk profile – and FDIC guidance is written accordingly.
- Financial institutions may not have enough time to correct FDIC’s identified concerns.



Federal Deposit Insurance Corporation
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Division of Risk Management Supervision

July 30, 2018

TO: Stephen M. Beard, Acting Assistant Inspector General
Office of Inspector General

FROM: Doreen R. Eberley, Director /**Signed**/
Division of Risk Management Supervision

SUBJECT: OIG Evaluation No. 2017-017 Forward-Looking Supervision

Thank you for providing the Federal Deposit Insurance Corporation (FDIC) the opportunity to comment on the draft evaluation report (Draft Report) for Assignment No. 2017-017, "Forward-Looking Supervision," which focused on the FDIC's implementation of forward-looking supervision in financial institutions with concentrations in commercial real estate (CRE) or acquisition, development, or construction (ADC) loans.

We appreciate the overall conclusion, based on the institutions sampled by the Office of Inspector General (OIG) staff, that examiners substantially achieved the intended outcomes of the FDIC's forward-looking supervision approach, which implements the forward-looking supervision concepts embedded in the Uniform Financial Institution Rating System. We additionally concur with the recommendations made by the OIG to further strengthen the FDIC's risk-focused supervision program.

RECOMMENDATIONS

(1) Issue a comprehensive written policy statement defining Forward-Looking Supervision, including its purpose, goals, roles, and responsibilities.

Concur. The Division of Risk Management Supervision (RMS) will issue a comprehensive, public document describing its risk-focused supervision program, including how FDIC implements the forward-looking supervision concepts embedded in the Uniform Financial Institution Rating System. The document will include the program's purpose, goals and objectives, and the roles and responsibilities RMS personnel play in carrying out risk-focused supervision. RMS will finalize this document and make it available to the public on the FDIC's website by year-end 2018.

(2) Issue guidance to reinforce the use of the Concentrations page during financial institution examinations.

Concur: RMS will issue instructions to examiners to reinforce the use of the Concentrations page during financial institution examinations by September 30, 2018. RMS will also provide clarifications to the guidance at the same time.

(3) Provide additional case studies on Forward-Looking Supervision to strengthen training for examiners on the analysis and identification of potential financial institution risk management weaknesses.

Concur: RMS has developed several case studies illustrating forward-looking concepts that were an integral part of the 2017/2018 commissioned examiner training. Building on the success of the case study approach, RMS is developing a case study covering the comprehensive supervision of a composite failed institution, a liquidity-focused case study, as well as instructions to examiners on responding to common risk management weaknesses that will also contain case study examples as appendices. The instructions and clarifications developed in response to recommendation (2) will contain additional examples for examiners. These materials will be discussed with all RMS managers during October 2018 and will be issued to all staff thereafter. The case study materials and instructions will be made available to field managers and subject matter experts for use in training field territory staff. Training will be completed by the end of 2018.

(4) Conduct recurring retrospective reviews to validate that examiners thoroughly documented their written analyses of the financial institution practices regarding concentration risk management.

Concur: RMS conducts recurring retrospective reviews of examiners' written analyses of concentration risk management as part of its internal control reviews of each regional office every three years, and will continue to do so.

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: ^a Yes or No	Open or Closed ^b
1	RMS will issue a comprehensive, document describing its risk-focused supervision program, including how the FDIC implemented Forward-Looking Supervision concepts. The document will include the program's purpose, goals and objectives, and the roles and responsibilities RMS personnel play in carrying out risk-focused supervision.	December 2018	No	Yes	Open
2	RMS will issue instructions to examiners to reinforce the use of the Concentrations page during financial institution examinations.	September 2018	No	Yes	Open
3	RMS is developing a case study covering the comprehensive supervision of a composite failed institution, a liquidity-focused case study, as well as instructions to examiners on responding to common risk management weaknesses that will contain case study examples as appendixes. RMS will issue the materials to all staff and they will be available for use in training field territory staff.	December 2018	No	Yes	Open
4	RMS conducts recurring retrospective reviews of examiners' written analyses of concentration risk management as part of its internal control reviews of each regional office every three years, and will continue to do so. A review of the Dallas Region is ongoing and RMS expects to complete it in March 2019.	March 2019	No	Yes	Open

^a 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.

^b Recommendations will be closed when the OIG confirms that corrective actions have been completed and are responsive.



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