

October 6, 2016

**TO:** The Board of Directors

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

**SUBJECT:** *Final rules.* Expanded Examination Cycle for Certain Small Insured Depository Institutions and U.S. Branches and Agencies of Foreign Banks

**Summary:** The Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (FRB), and Office of the Comptroller of the Currency (OCC) (collectively, the agencies), jointly amended their regulations with regard to the examination cycle for certain small insured depository institutions consistent with amendments to section 10(d) of the Federal Deposit Insurance Act (FDI Act) made by section 83001 of the Fixing America's Surface Transportation Act, P.L. 114-94 (FAST Act) with the issuance of interim final rules in the *Federal Register* dated February 29, 2016. The FAST Act permits insured depository institutions that have up to \$1 billion (from the previous \$500 million) in total assets, and that meet certain other criteria, to qualify for an 18-month, on-site examination cycle. The interim final rules amended 12 CFR section 337.12, *Frequency of Examination* and 12 CFR section 347.211, *Examination of Branches of Foreign Banks*, to permit institutions with up to \$1 billion (rather than the previous \$500 million) in total assets that received a composite rating of outstanding or good at the most recent examination, and meet certain other criteria, to qualify for an 18-month on-site examination cycle.

Additionally, to streamline the FDIC's regulations, the interim final rules rescinded and removed a transferred Office of Thrift Supervision regulation, 12 CFR section 390.351, *Frequency of Safety and Soundness Examination*. This section contained provisions that were substantially similar to 12 CFR section 337.12, and the interim final rule consolidated regulations relating to both insured State nonmember banks and State savings associations.

The proposed final rules will adopt the interim final rules without change.

**Recommendation:** That the Board adopt and issue the attached final rules as indicated and authorize publication in the *Federal Register*.

Concur:

  
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Charles Yi  
General Counsel

## Discussion

### Background

Section 10(d) of the FDI Act<sup>1</sup> generally requires that the appropriate Federal banking agency for an insured depository institution conduct a full scope, on-site examination of the institution at least once during each 12-month period. Prior to enactment of the FAST Act, section 10(d) also authorized the appropriate Federal banking agency to extend the on-site examination cycle for an insured depository institution to at least once during an 18 month period if the institution (1) had total assets of less than \$500 million; (2) was well capitalized (as defined in 12 U.S.C. 1831o; (3) was found, at its most recent examination, to be well managed and to have a composite condition of outstanding or good;<sup>2</sup> (4) was not subject to a formal enforcement proceeding or order by the FDIC or its appropriate Federal banking agency; and (5) had not undergone a change in control during the previous 12-month period in which a full-scope, on-site examination otherwise would have been required. The agencies previously adopted regulations to implement the examination cycle requirements of section 10(d) of the FDI Act and section 7(c)(1)(C) of the International Banking Act (IBA), including the extended 18-month examination cycle available to qualifying small institutions and foreign bank offices. Prior to the enactment of the FAST Act, a qualifying small insured depository institution was one holding total assets of less than \$500 million.

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<sup>1</sup> Section 10(d) of the FDI Act was added by section 111 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) and is codified at 12 U.S.C. 1820(d).

<sup>2</sup> Under section 10(d) of the FDI Act, before enactment of the FAST Act, the Agencies had the authority to extend the 18-month examination cycle to institutions with composite CAMELS ratings of 2 and assets up to \$500 million. Section 10(d) required the Agencies to determine that extending the 18-month cycle in this manner would be consistent with safety and soundness. (See 62 FR 6449, February 12, 1997 (interim rule); see also 63 FR 16377, April 2, 1998 (final rule); see also 72 FR 17798, April 10, 2007 (interim rule); see also 72 FR 54347 September 25, 2007 (final rule)). CAMELS is an acronym drawn from the first letters of the individual components of the Uniform Financial Institutions Rating System: Capital adequacy, Asset quality, Earnings, Management, Liquidity, and Sensitivity to market risk.

The FRB and the FDIC, as the appropriate Federal banking agencies for state-chartered insured banks and state-chartered savings associations, are permitted to conduct on-site examinations of such institutions on alternating 12-month or 18-month periods with the institution's State supervisor, if the FRB and the FDIC, as appropriate, determine that the alternating examination conducted by the State carries out the purposes of section 10(d) of the FDI Act.

In addition, section 7(c)(1)(C) of the IBA provides that a Federal and a State branch or agency of a foreign bank shall be subject to on-site examination by its appropriate Federal banking agency or State banking supervisor as frequently as a national or state bank would be subject to such an examination by the agency.<sup>3</sup>

Section 83001 of the FAST Act, effective on December 4, 2015, amended section 10(d) of the FDI Act to raise, from \$500 million to \$1 billion, the total asset threshold below which an insured depository institution may qualify for an 18-month on-site examination cycle and to raise, from not more than \$100 million to not more than \$200 million, the total asset threshold below which an insured depository institution with an outstanding or good composite condition may qualify for an 18-month on-site examination cycle. Section 83001 also amended section 10(d)(10) of the FDI Act to authorize the appropriate Federal banking agency to increase, by regulation, the maximum amount limitation from not more than \$200 million to an amount not to exceed \$1 billion, if the agency determines that the greater amount would be consistent with the principles of safety and soundness for insured depository institutions. This provision would

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<sup>3</sup> 12 U.S.C. 3105(c).

permit the agencies to make a finding about safety and soundness for institutions rated outstanding or good with total assets between \$200 million and \$1 billion.<sup>4</sup>

These FAST Act amendments reduce regulatory burdens on small, well capitalized, and well managed institutions and allow the agencies to better focus their supervisory resources on those insured depository institutions and U.S. branches and agencies of foreign banks that may present capital, managerial, or other issues of supervisory concern. The agencies will continue to use off-site monitoring tools to identify potential problems in smaller, well capitalized, and well managed institutions. Moreover, the statute does not limit the ability of the agencies - and the agencies' regulations reserve the right - to examine an insured depository institution or U.S. branch or agency of a foreign bank more frequently than would be required by the FDI Act or the IBA.

#### Description of the Final Rules

In the final rules, the agencies would adopt the interim final rules without change. The interim final rules implemented the recent amendments to section 10(d) of the FDI Act. Consistent with section 7(c)(1)(C) of the IBA, the agencies also made conforming changes to their regulations governing the on-site examination cycle for the U.S. branches and agencies of foreign banks. In particular, the agencies amended their respective rules to raise, from \$500 million to \$1 billion, the total asset threshold below which an institution that meets both the qualifying criteria in section 10(d) and the agencies' rules may qualify for an 18-month, on-site examination cycle. In addition, as authorized by the FAST Act, the agencies determined that it is consistent with safety and soundness principles to permit institutions with total assets from \$200

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<sup>4</sup> Public Law No. 109-47, which became effective on January 11, 2007, also amended section 10(d)(10) of the FDI Act to authorize the appropriate Federal banking agency, if it determines the action would be consistent with principles of safety and soundness, to allow an insured depository institution that falls within this expanded total asset threshold to qualify for an 18-month examination cycle if the institution received a composite rating of outstanding or good at its most recent examination

million and less than \$1 billion that received a composite CAMELS, rating of “1” or “2,” or, for foreign branches, a Risk management, Operational controls, Compliance, and Asset quality system (ROCA) of “1” or “2”<sup>5</sup> and that met the other qualifying criteria set forth in section 10(d) and the agencies’ rules, to qualify for an 18-month examination cycle.

FDIC staff analyzed the frequency with which institutions rated a composite CAMELS rating of “1” or “2” failed within five years versus the failure rate for institutions rated “3,” “4,” or “5” during the same period. FDIC analysis indicates that between 1985 and 2010 (using bank failure data through 2015) FDIC-insured depository institutions with assets less than \$1 billion and a composite CAMELS rating of “1” or “2” had a five-year failure rate that was one-seventh as high as institutions with a CAMELS rating of “3,” “4,” or “5.” Moreover, the relationship between failure rates in the two ratings groups does not meaningfully change when the analysis is restricted to institutions with assets between \$200 million and \$500 million compared to institutions with assets between \$500 million to \$1 billion. This suggests that extending the examination cycle for well-rated institutions with \$500 million to \$1 billion in assets by an additional six months combined with the agencies’ off-site monitoring activities and ability to examine an institution more frequently as necessary or appropriate, will not negatively affect the safe and sound operations of qualifying institutions or the ability of the agencies to effectively supervise and protect the safety and soundness of institutions with total assets of less than \$1 billion.

The agencies estimate that the FAST Act amendments increased the number of institutions that may qualify for an extended 18-month examination cycle by approximately 611 institutions (372 of which are supervised by the FDIC, 142 by the OCC, and 97 by the FRB),

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<sup>5</sup> For U.S. branches and agencies of foreign banks, the composite ROCA rating is comparable to the CAMELS rating.

bringing the total number to 4,793 insured depository institutions. Approximately 89 foreign branches and agencies would be eligible for the extended examination cycle based on the FAST Act amendments, for an increase of 30 offices. (1 of which is supervised by the FDIC, 4 by the OCC, and 25 by the FRB).

#### Consistent Treatment for Insured State Savings Associations Regarding Examination Frequency

An Office of Thrift Supervision (OTS) rule transferred to the FDIC governs the frequency of safety and soundness examinations of State savings associations. The OTS rule, formerly found at 12 CFR section 563.171, was transferred to the FDIC with nominal changes and was found in 12 CFR 390.351 of the FDIC rules and regulations. The FDIC's rule contained in 12 CFR 337.12 governs the frequency of safety and soundness examinations for State nonmember banks. After careful review and comparison of section 390.351 and section 337.12, the staff determined that the rules were substantively identical. Therefore, the final rules, like the interim final rules, reference the rescission of section 390.351 and amendment of section 337.12 to apply its requirements to all FDIC-supervised institutions, including State savings associations.

#### Comments

The agencies received three comment letters in response to the interim final rules. Two commenters, both industry trade groups, supported the interim final rules. Both commenters agreed that extending the examination cycle for insured depository institutions that meet the interim final rules' criteria would not negatively affect these institutions' safe and sound operations or the ability of the agencies to supervise them. The third commenter, an individual, did not support the interim final rules, but offered no specific reasons for that opposition.

Effective Date

The final rules will become effective 30 days from the date they are published in the *Federal Register*. The interim final rules continue in effect until the final rules become effective.

**Conclusion**

FDIC staff recommends that the Board adopt the attached final rules and authorize publication in the *Federal Register*. If approved by the Board, and subject to the other agencies' approval processes, the final rules would be published jointly by the agencies in the Federal Register.

Staff Contacts:

RMS		Legal	
Karen Currie	ext. 8-3981	Mark Mellon	ext. 8-6858
		Rodney Ray	ext. 8-3556
		Sue Dawley	ext. 8-6509