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## INTRODUCTION

This section describes the long standing philosophy and methods of the FDIC for examining institutions using a risk-focused, forward-looking approach. Each supervised institution is unique, based on its business model, complexity, and risk profile. Accordingly, examiners and case managers are expected to apply the instructions in this policy, as well as related instructions elsewhere in the FDIC's Risk Management Supervision Manual of Examination Policies (Manual) consistent with each institution's unique circumstances. The instructions set forth in this section are directed to FDIC supervisory personnel<sup>1</sup> in the conduct of supervisory activities and do not require action on the part of insured institutions. The principles discussed herein apply to both point-in-time and continuous examination approaches, though some specific activities discussed may differ.

### Purpose of Examinations

An examination is the process whereby supervisory personnel of a regulatory agency evaluate financial institutions' conditions, management processes,<sup>2</sup> and future prospects; identify deficiencies that may threaten their soundness; assess their compliance with applicable laws and regulations; and develop recommendations for corrective action, as appropriate.

Consistent with its mission, the FDIC conducts financial institution examinations to ensure public confidence in the financial system and to protect the Deposit Insurance Fund. Maintaining public confidence in the financial system is essential because customer deposits are a primary funding source that depository institutions use to meet fundamental objectives such as providing financial services. Safeguarding the integrity of the Deposit Insurance Fund is necessary to protect customers' deposits and resolve failed institutions.

On-site examinations help ensure the stability of insured depository institutions by identifying undue risks and weak risk management practices. Additionally, examinations play a key role in the supervisory process by helping the FDIC identify the root cause and severity of problems at individual institutions and emerging risks in the financial-

services industry. Accurately identifying existing problems and emerging risks helps the FDIC develop effective corrective measures for individual institutions and broader supervisory strategies for the industry.

### Uniform Financial Institutions Rating System

The federal financial institution supervisory agencies endeavor to ensure that all financial institutions are evaluated in a comprehensive and uniform manner, and that supervisory attention is appropriately focused on the financial institutions exhibiting financial and operational weaknesses or adverse trends. To promote this goal, the Federal Financial Institutions Examination Council (FFIEC) adopted the Uniform Financial Institutions Rating System (UFIRS) on November 13, 1979. The original rating system was designed to reflect, in a comprehensive and uniform fashion, an institution's financial condition, compliance with laws and regulations, and overall operating soundness.

The FFIEC revised the UFIRS on December 19, 1996, effective January 1, 1997.<sup>3</sup> The revised rating system, known as CAMELS,<sup>4</sup> reflects an increased emphasis on risk management processes. The Federal supervisory agencies historically considered the quality of risk management practices when applying the UFIRS, particularly in the management component; however, by 1996, changes in the financial services industry had broadened the range of financial products offered by institutions and accelerated the pace of transactions. Those trends reinforced the importance of institutions having sound risk management systems. Accordingly, the revised rating system added an explicit reference to the quality of risk management processes in the management component, and the identification of risk elements within the composite and component rating descriptions.

Management practices, particularly as they relate to risk management, vary considerably among financial institutions depending on their size and sophistication, the nature and complexity of their business activities, and their risk profile. Each institution must properly manage its risks and have appropriate policies, processes, or practices in place that management follows and uses. Activities undertaken in a less complex institution engaging in less sophisticated risk-taking activities may only need basic

<sup>1</sup> This term includes Risk Management Supervision staff such as examiners, field managers, case managers, and regional office management and is used throughout this document when a responsibility may be handled by varying parties based on regional management discretion.

<sup>2</sup> Management processes include an institution's corporate governance structure, policies, and procedures.

<sup>3</sup> See [62 Fed. Reg. 752](#), January 6, 1997, effective January 1, 1997.

<sup>4</sup> Under the UFIRS, each financial institution is assigned a composite rating based on an evaluation of six financial and operational components, which are also rated. The component ratings reflect an institution's capital adequacy, asset quality, management capabilities, earnings sufficiency, liquidity position, and sensitivity to market risk (commonly referred to as the CAMELS ratings).

management and control systems compared to the detailed and formalized systems and controls needed for the broader and more complex range of activities undertaken at a larger and more complex institution.

The UFIRS takes into consideration certain and compliance factors that are common to all institutions. Compliance with laws and regulations is considered under the management component. Specialty examination findings (Compliance, Community Reinvestment Act, Government Security Dealers, Information Technology, Municipal Security Dealers, Transfer Agent, and Trust (or Fiduciary)) and the ratings assigned to those areas are taken into consideration, as appropriate, when assigning a composite rating and component ratings under UFIRS.

Peer comparison data are not included in the rating system. The principal reason is to avoid over reliance on statistical comparisons to justify the component rating being assigned. Examiners are encouraged to consider all relevant factors when assigning a component rating. The rating system is designed to reflect an assessment of the individual institution, including its size and sophistication, the nature and complexity of its business activities, and its risk profile.

Over the years, the UFIRS has proven to be an effective internal supervisory tool for evaluating the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special attention or concern.

### Risk-Focused Approach to Examinations

Risk-focused supervision was adopted by the FDIC, the Board of Governors of the Federal Reserve System, and the Conference of State Bank Supervisors on October 1, 1997, as a framework for carrying out examination activities. The FDIC described the then new framework as employing a tiered approach to supervision to assist examiners in establishing an appropriate examination scope and managing resources by focusing those resources on the areas in an institution presenting the greatest risks.<sup>5</sup>

The objective of a risk-focused examination is to evaluate the safety and soundness of the financial institution by assessing its risk management systems, financial condition, and compliance with applicable laws and regulations, while focusing on the bank's highest risks. The risk-focused examination process seeks to strike an appropriate balance between evaluating the condition of an institution at a

certain point in time<sup>6</sup> and evaluating the soundness of the institution's processes for managing risk in all phases of the economic cycle. By evaluating an institution's risk management practices, examiners look beyond the financial condition of a bank at a point in time, to how well it can respond to changing market conditions given its particular risk profile. The UFIRS emphasizes the importance of sound risk management processes by including them as a significant factor in the definition for each component rating and the overall composite rating.

To achieve the risk-focused examination objective, FDIC supervisory personnel are expected to adhere to the following risk-tailoring principles and practices:

- Recognize there are financial institutions, or areas within institutions, that present low risk, and in those cases, minimum (or baseline) examination procedures are generally sufficient to assess the institution's condition and risks.
- Allocate more examination resources to higher risk areas and fewer resources to lower risk areas.
- Use data from the quarterly Call Report filings and other available information to monitor changes to the institution's business model, complexity, and risk profile between examinations.
- Leverage available information, including analyses and conclusions from ongoing off-site monitoring and previous examinations, to determine the financial institution's risk profile and the scope of the next examination or examination activity.
- Consider the financial institution's ability to identify and control risks when risk-focusing examinations.
- Tailor the pre-examination request list to the institution's business model, complexity, and risk profile.
- Contact the institution between examinations or prior to finalizing the scope of the examination to help inform an examiner's assessment of an institution's risk profile.
- Follow up between examinations on the institution's actions taken to address areas in need of improvement.

Further, FDIC personnel are expected to adhere to the following communication principles:

- Provide appropriate prior notification of the upcoming examination and address staffing and logistical issues.

complex institutions. While the supervisory plan and continuous examination processes and procedures may differ in some respects from the point in time approach, the principles contained within this section are applicable to examination activities for all institutions supervised by the FDIC.

<sup>5</sup> See [FDIC 1997 Annual Report](#).

<sup>6</sup> In addition to point-in-time examinations, the FDIC utilizes targeted reviews conducted under a supervisory plan, guiding a continuous examination program for certain institutions. These other programs are generally warranted to ensure effective monitoring and examination activity related to larger and more

- Tailor the examination request list and scope to the unique risk profile and business model of the institution.
- Facilitate the secure exchange of information between institution management and examiners.
- Inform institution management of areas under review and provide management the opportunity to communicate any additional information or clarification before the conclusion of the examination.
- Establish clear expectations regarding items and examination findings that the financial institution is expected to address.<sup>7</sup>

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## RISK-FOCUSED, FORWARD-LOOKING EXAMINATION PROCEDURES

Section 10(b) of the FDI Act requires the FDIC to conduct full-scope, on-site safety and soundness examinations of its supervised institutions.<sup>8</sup> Risk-focused, full-scope examinations assess the types and extent of risks to which a banking organization is exposed, evaluate the organization's methods of managing and controlling its risk exposures, ascertain whether management and directors fully understand and are actively monitoring the organization's exposure to these risks, and evaluate compliance with banking laws and regulations. Risk-focused, full-scope examinations are forward looking in that they address weaknesses in risk management practices before they lead to financial deterioration or operational problems.

The risk-focused supervision approach to examinations is not composed of a fixed set of routine procedures. Rather, the procedures that constitute a full-scope examination depend on the nature and complexity of the institution's business activities, and its risk profile. At a minimum, however, full-scope examinations must include sufficient procedures to reach an informed judgment on the financial, managerial, operational, and compliance factors rated under the CAMELS rating system.<sup>9</sup> An examination meeting those requirements would meet the FDIC's definition of a full-scope examination.

<sup>7</sup> The FDIC participated in the FFIEC Examination Modernization project to identify and assess ways to improve the effectiveness, efficiency, and quality of financial institution safety and soundness examination processes, with the expectation to help reduce unnecessary regulatory burden. Expectations for examiners to adhere to risk-tailoring and clear communications practices are part of the project. See FFIEC press releases related to Examination Modernization dated [March 22, 2018](#) and [November 27, 2018](#).

<sup>8</sup> [Federal Deposit Insurance Act](#).

## Understanding the Institution

To conduct a risk-focused examination, examiners must understand the nature, scope, and risk of an institution's activities. The nature and scope of an institution's activities are commonly referred to as the institution's business model. The examiner will develop a written description of the bank's business model by identifying the activities in which a banking organization has chosen to engage.

The risk associated with an institution's business model is commonly referred to as the risk profile. The examiner will develop a written description of the bank's preliminary risk profile by determining the types and quantities of risks inherent in the bank's business model and the quality of the risk management practices used by bank management to control these risks.

A key component of both an institution's business model and risk profile is the complexity of its operations. The examiner will develop a written description of the complexity of an institution's operations through a review of its balance sheet structure and scope of operations.

*Business Model* – To evaluate and develop a written description of an institution's business model, an examiner will consider:

- The primary market area and customer base served;
- The organizational/ownership structure, strategic plan/focus, and philosophical approaches/risk appetite management is using to pursue its objectives;
- The primary lending activities and funding sources, including any concentrations;
- Any product line, activity, or service that represents a significant portion of assets or revenue;
- Any unique or niche characteristics;
- Any significant third-party relationships, including technology service providers; and
- Any significant use of new or emerging technologies to support customer products or bank operations, whether offered alone by the institution or offered with a third party.

<sup>9</sup> This could include, as appropriate, risk management for Information Technology (IT), Bank Secrecy Act (BSA)/Anti-Money Laundering (AML)/Office of Foreign Assets Control (OFAC) reviews, Trust, Registered Transfer Agent, Municipal Securities Dealer, and Government Securities Dealer examination programs. These specialty examination areas are incorporated into CAMELS through the Management component rating, as outlined in the UFIRS. See [62 Fed. Reg. 752, January 6, 1997, effective January 1, 1997](#).

*Risk Profile* – To evaluate and develop a written description of an institution’s preliminary risk profile, the examiner reviews the bank’s business model, its current financial condition, and trends in its financial condition. The examiner reviews information available within the FDIC, including prior Reports of Examination and workpapers, correspondence, applications and other filings, the Uniform Bank Performance Report, interim contacts, and off-site review reports. Further, the examiner communicates with the case manager and other FDIC stakeholders to obtain additional information.

The examiner also considers the quality of institution management’s policies, practices, and processes in determining the risk profile of an institution. Such policies, practices, and processes are indicators of an institution’s governance and risk management framework, and can provide information to evaluate the institution’s ability to withstand and respond to internal and external challenges, including unforeseen scenarios (e.g., competition, adverse economic conditions).

The nature and scope of an institution’s activities influence the robustness of risk management practices for mitigating credit, market, operating, or transaction, strategic, compliance, legal, liquidity, and other risks. The examiner considers the inherent risks of the bank’s activities and the strength of risk mitigation practices when developing and documenting the current risk profile of the bank. This process enables the examiner to identify areas of greater risk that will be emphasized in conducting the examination.

Risk management practices are primarily assessed considering the guidelines for the safe and sound operation of banks set forth in Section II of Part 364 of the FDIC Rules and Regulations, Appendix A,<sup>10</sup> though other regulations are also considered. These guidelines set out safety and soundness standards that the agencies use to identify and address problems at institutions before capital becomes impaired.<sup>11</sup> The guidelines are qualitative rather than quantitative; they establish the objectives of proper operations and management, but leave the specific methods of achieving those objectives to each institution. They are also designed to be flexible based on the nature of activities at the bank. The guidelines cover the following areas:

- Internal controls and information systems;
- Internal audit systems;
- Loan documentation;
- Credit underwriting;
- Interest rate exposure;
- Asset growth;
- Asset quality;
- Earnings; and
- Compensation, fees, and benefits.

*Complexity* – A key component of both the institution’s business model and risk profile is the complexity of its operations. To determine complexity within an institution’s products, services, and delivery channels, the examiner evaluates a combination of factors, including, but not limited to, the sophistication of a particular activity or business line, risk presented by the activity, volume and scope of the activity, and interconnectedness among various activities and business lines within the institution. The examiner also considers strategic initiatives of the institution that impact the business model, risk profile, and complexity of the institution. In describing complexity, the examiner considers:

- Structure – balance sheet composition, off-balance sheet activities, asset and funding concentrations, organizational and management structure, branching activities, merger and acquisition activities, and geographic footprint; and
- Operations – business lines, customer base, product and service offerings, number and type of deposit and lending transactions, delivery systems, international exposure, operational risk,<sup>12</sup> and specialty areas.<sup>13</sup>

## Planning the Examination<sup>14</sup>

Section 21.1 entitled Examination Planning provides information in relation to preparing for a Risk-Focused, Forward-Looking Safety and Soundness Examination. This section notes that the purpose of the examination planning process is to ensure that the institution’s operations and activities are understood prior to the start of the examination, so that examination procedures can be appropriately tailored to the institution.

submission of a separate safety and soundness compliance plan. The FDIC may also seek corrective action through a Matter Requiring Board Attention.

<sup>12</sup> Includes BSA/AML and IT, including cybersecurity.

<sup>13</sup> Includes trust and asset management, consumer compliance, Community Reinvestment Act, registered transfer agent, government-securities dealers, and municipal-securities dealers.

<sup>14</sup> For the purposes of this discussion, planning of targeted reviews conducted as part of a continuous examination approach focuses on the subject of the review, where the point-in-time examination would encompass all aspects of a full scope examination.

<sup>10</sup> See [Appendix A to Part 364 - Interagency Guidelines Establishing Standards for Safety and Soundness](#).

<sup>11</sup> If an institution fails to meet a standard prescribed by guideline, the FDIC may request the institution to submit an acceptable plan to achieve compliance with the standard. The FDIC generally expects to request submission of a compliance plan from an institution whose failure to meet one or more standards is of such severity that it could threaten the safe and sound operation of the institution. In other situations, the FDIC may elect to rely on an existing plan or enforcement action to ensure that an institution achieves compliance with the guidelines, rather than requiring the

The Examination Planning process includes several key activities, including contacting the institution, developing an understanding of the risks, tailoring the request list, identifying on-site and off-site procedures, and developing a written examination plan.

Refer to Section 21.1 for additional details regarding examination planning.

## Conducting the Examination

Prior to the on-site portion of the examination, the examination team conducts off-site examination activities to review and analyze available information, including materials provided by the bank. During this timeframe, the EIC updates the examination plan, factoring in the review of requested materials, and submits the plan to field management for final approval.

During the off-site examination process, or on the first day of the examination, the EIC invites board members to attend any or all meetings conducted during an examination. Their attendance often improves communication with outside directors and increases director knowledge of the examination process. These meetings also provide an opportunity for directors to discuss their views with examiners on bank-related matters, and give examiners the opportunity to gain further insight into the experience levels and leadership qualities of bank management. While encouraging participation in these meetings, the EIC should emphasize that attendance is voluntary and that a lack of participation will not be viewed negatively.<sup>15</sup>

As soon as practicable, on or after the first day of the on-site portion of the examination, the EIC and on-site portion of the examination team meet with appropriate institution management to open lines of communication, develop plans for ongoing communication during the examination, and discuss any other informational needs or other issues. The EIC describes how document request materials obtained from the institution are being used during the examination. Informal meetings are held as needed throughout the examination to discuss various topics, including but not limited to following up on previous examination issues, discussing strategic and business plans, discussing loan review results, and discussing other material preliminary findings.

The EIC is expected to coordinate regular communication among examination team members, such as examination team meetings, conference calls, or group emails, so that team members may share and discuss observations and

findings. Team communication should occur at least once per week; more frequent communication may be appropriate if examination teams are dispersed.

Based on the risk presented by the institution, examiners are expected to perform an appropriate level of transaction testing to verify: the adequacy of and adherence to internal policies, procedures, and limits; the accuracy and completeness of management reports and financial reports; the adequacy and reliability of internal control systems; the effectiveness of the bank's risk management processes and practices; and compliance with laws and regulations.

Examiners have the flexibility, subject to appropriate concurrence, to adjust the examination scope at any point during the examination based on findings to date. EICs will discuss proposed changes with their manager. EICs are to obtain written concurrence from their manager<sup>16</sup> prior to implementation of material changes to the examination scope.

The manager will provide a copy of the written concurrence to the appropriate regional office case manager. The rationale for changes in the examination plan will be clearly communicated to institution management, along with any significant adjustments to the breadth or depth of procedures, personnel, examination hours, and examination schedule.

## Communicate Preliminary Findings

Sufficiently in advance of exit meetings with institution management, the EIC provides and discusses preliminary findings, ratings, and supervisory recommendations with the Field Supervisor and Case Manager.

Prior to the conclusion of the examination, examiners thoroughly discuss the tentative findings and supervisory recommendations with senior institution management, including the tentative CAMELS ratings assigned under the UFIRS, clearly indicating that ratings are subject to FDIC regional office review. Such meetings are critical in communicating tentative examination findings to institution management and providing management an opportunity to respond.

During exit meetings, the EIC fully apprises institution management of examination findings and conclusions, including explaining the reasoning for proposed ratings and supervisory recommendations that will be cited in the ROE. Examiners also describe how document request materials

<sup>15</sup> See Risk Management Manual of Examination Policies, pages [1.1-14-15](#).

<sup>16</sup> The appropriate manager will be the supervisory examiner or field supervisor for point-in-time examinations and the assistant regional director for continuous examinations.

obtained from the institution were used during the examination to support findings.

### Prepare the Report of Examination<sup>17</sup>

The EIC prepares the ROE in accordance with the FDIC's ROE Instructions<sup>18</sup> contained within the Risk Management Supervision Manual of Examination Policies (Manual). Consistent with the forward-looking aspects of the risk-focused examination process, the ROE is designed to clearly convey issues that are cause for concern, explain the risks to the institution's operations or financial performance if not addressed in a timely manner, and recommend appropriate corrective/remedial action.

Within the ROE, supervisory recommendations are used to inform the institution of the FDIC's views about changes needed in the bank's practices, operations, or financial condition. Matters Requiring Board Attention (MRBA) is a subset of supervisory recommendations that need prompt action by the board of directors and senior management. The intent of supervisory recommendations and MRBAs is to establish clear expectations regarding items the institution should address in order to correct deficiencies before they cause deterioration in the bank's financial condition.

### Meet with the Institution's Board of Directors

The FDIC conducts meetings with boards of directors to encourage director involvement in, and enhance director awareness of, FDIC's supervisory efforts and to increase the effectiveness of such efforts.<sup>19</sup> Such meetings also provide an opportunity to discuss and exchange views on bank specific and industry related issues that may be outside the scope of the examination, but are important for promoting safe and sound operations; examples include planned bank initiatives or new or proposed banking regulations.

The EIC meets with the board or a board committee during or subsequent to the examination when 36 months or more have elapsed since the last such meeting; the management component of the CAMELS rating is 3, 4 or 5; any other CAMELS performance rating is 4 or 5; or any two performance ratings are 3, 4 or 5. Other factors that may be relevant to the decision of holding a board meeting include whether:

- The ROE contains MRBAs;
- The institution has undergone a recent change in control, ownership, or top management;

- The institution is operating in adverse economic conditions;
- The institution's management or board has requested a meeting; or
- There exist any other unique conditions or trends pertinent to the institution.

An institution's composite rating is an important variable in determining regional office participation in a board meeting. While regional office participation in meetings with banks rated composite 1, 2, or 3 is at the regional director's discretion, the regional director or designee will participate in the board meeting of a bank with a composite rating of 4 or 5.

### Submit the ROE for Regional Office Review and Issuance to the Institution

The EIC notifies institution management when the draft report is submitted to the assigned regional office case manager for review. The assigned case manager is expected to ensure that the ROE clearly identifies areas of risk and contains appropriate supervisory recommendations to mitigate those risks, supervisory recommendations address the causes of deficiencies, supervisory recommendations that warrant board attention are scheduled as MRBAs in accordance with existing Manual instructions, and CAMELS ratings are supported and are consistent with UFIRS definitions.

Supervisory personnel keep institution management informed of any changes made to the ROE findings that differ significantly from the initial findings disclosed at the exit meetings with institution management. Examples of significant changes include, but are not limited to, a revision to any rating or the addition or deletion of a supervisory recommendation or an apparent violation. FDIC supervisory personnel will explain the reasons for the changes to initial examination findings, and institution management will be given a reasonable amount of time to re-confirm or change responses and commitments, as appropriate.

The FDIC has established internal goals to ensure the timely sharing of information with financial institutions. These goals include transmitting Safety and Soundness ROEs to financial institutions within a median 75 days from the on-site examination start date and concluding regional office processing of Safety and Soundness ROEs within a median 45 days from the EIC's submission of the ROE to the regional office. The FDIC reports its performance relative

<sup>17</sup> For targeted reviews where a full ROE is not to be issued, these concepts apply similarly to a supervisory letter.

<sup>18</sup> See Risk Management Manual of Examination Policies, Section 19.1.

<sup>19</sup> Risk Management Manual of Examination Policies, [page 1.1-16](#).

to these goals on the FDIC's *Trust through Transparency* [webpage](#). The case manager keeps institution management informed should unusual processing delays occur and provides the reasons for such delay.

The regional office transmits the ROE to the institution's board of directors with a letter summarizing the examination findings. In some cases, the transmittal letter will also request that the board provide a written response to the examination. Institution management is also invited to complete a post examination survey after each examination.<sup>20</sup> The survey is part of the FDIC's continuing effort to improve the quality and efficiency of the examination process. Institution management is invited to complete the survey via a secure FDIC Website using an access code provided in a separate invitation letter. All responses are submitted directly to the FDIC's headquarters office and will be confidential. The FDIC uses the survey results to identify ways to improve the examination process.

### Post-Examination Responsibilities

Safety and soundness supervision is an ongoing process of planning and conducting examinations, following up on the resolution of supervisory findings and supervisory recommendations, and monitoring institutions between examinations.

#### Enforcement Actions

Should an enforcement action be deemed necessary to address deficiencies identified during the examination, regional office personnel, with input from the EIC, develop the appropriate level of supervisory action (formal or informal) and engage the board of directors and management to ensure understanding and procure adoption. Once an enforcement action has been adopted, case managers review implementation progress reports submitted under the enforcement action to monitor the institution's corrective actions.

#### Following up on Examination Findings

The institution's assigned case manager reviews institution management's response to the ROE, as applicable, and follows up on the disposition and resolution of MRBAs. Staff assigned to the Division Director will contact institution management in response to any request for post-examination contact within the post examination survey.

#### Ongoing Monitoring and Interim Contacts

The assigned case manager serves as the institution's point-of-contact within the FDIC and will conduct ongoing

monitoring of the institution's risk trends and financial condition between examinations. Should the institution be flagged on any internal FDIC reports as an outlier based on quarterly Call Report data, the case manager reviews the data that caused the flag and may contact institution management, if needed, to obtain any additional information needed to review the matter. Further, the assigned case manager or field supervisor contacts institution management between examinations to inquire about any changes in institution operations, discuss topics of interest such as regulatory changes or industry trends, and answer questions from bank management.

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<sup>20</sup> [Post-Examination Survey](#).