

Board of Governors of the Federal Reserve System

The Bank Exams Tailored to Risk Process Promotes Risk-Focused Supervision of Community Banking Organizations, but Training Can Be Enhanced



Office of Inspector General

Board of Governors of the Federal Reserve System
Consumer Financial Protection Bureau



Executive Summary, 2025-SR-B-003, March 3, 2025

The Bank Exams Tailored to Risk Process Promotes Risk-Focused Supervision of Community Banking Organizations, but Training Can Be Enhanced

Findings

We found that the Bank Exams Tailored to Risk (BETR) process promotes tailored supervision of community banking organizations (CBOs), but the Board of Governors of the Federal Reserve System can enhance training on the BETR process.

Specifically, we found that examination staff in the Federal Reserve Banks we selected for review tailored the BETR-suggested risk classifications, examination hours, and procedures to supervised institutions. This approach aligns with the *Commercial Bank Examination Manual*, which states that examiners should tailor supervisory activities to an institution's condition, risk profile, and unique characteristics. Further, the Board encourages examination staff to apply supervisory judgment during the BETR process. By allowing examination staff to tailor their supervisory activities, the BETR process promotes risk-focused supervision and effective resource allocation.

Additionally, we found that some examination staff expressed interest in increasing their understanding of the BETR process and models. We attribute examination staff's desire for additional information on the BETR process and models to insufficient training on BETR and a lack of awareness about available resources. We believe that conducting additional training on the BETR process and models and reinforcing the training resources and guidance materials available to examination staff will enhance their ability to use BETR to scope examinations and will increase the effectiveness of the BETR process.

In addition, we identified a matter for management consideration related to creating guidance on using BETR for institutions with unique business models or novel activities.

Recommendations

Our report contains two recommendations designed to enhance the effectiveness of the Board and Reserve Banks' BETR process. In its response to our draft report, the Board concurs with our recommendations and outlines actions to address each recommendation. We will follow up to ensure that the recommendations are fully addressed.

Purpose

We conducted this evaluation to assess the Board and Reserve Banks' application of the BETR process for CBOs. The scope of our evaluation included the use of BETR to assess credit and liquidity risks in full-scope examinations led by the Federal Reserve Banks of New York, Kansas City, and San Francisco from January 1, 2022, through December 31, 2023.

Background

The Board plays a significant role in supervising and regulating financial institutions. Through its oversight, the Board seeks to ensure that the institutions under its supervisory authority operate in a safe and sound manner and comply with all applicable federal laws and regulations. The Board delegates to each Reserve Bank the authority to supervise certain financial institutions located within the Reserve Bank's district.

In 2019, the Board implemented the BETR process to facilitate risk-focused supervision. BETR helps examination staff determine the scope and supervisory resources for safety-and-soundness examinations of CBOs. The BETR process combines metrics with examiner judgment to classify the levels of risk at a state member bank and tailor the examination to reflect those risks. BETR consists of three interrelated components: risk assessments, risk-aligned examination hours, and risk-aligned procedures.



Recommendations, 2025-SR-B-003, March 3, 2025

The Bank Exams Tailored to Risk Process Promotes Risk-Focused Supervision of Community Banking Organizations, but Training Can Be Enhanced

Finding 1: The BETR Process Promotes Tailored Supervision of CBOs

Number	Recommendation	Responsible office
	No recommendations.	

Finding 2: The Board Can Enhance Training on Certain Aspects of the BETR Process and Models

Number	Recommendation	Responsible office
1	Develop training for examination staff that <ol style="list-style-type: none">provides an overview of the BETR model risk metrics, adjustment factors, and bump-up rules.provides an overview of the process for using BETR to scope an examination.reinforces the resources and guidance materials available to help examination staff understand these topics.	Division of Supervision and Regulation
2	Establish a process to periodically assess the need for additional training as the BETR Program redevelops the models and implements new adjustment factors and bump-up rules.	Division of Supervision and Regulation



Office of Inspector General

Board of Governors of the Federal Reserve System
Consumer Financial Protection Bureau

MEMORANDUM

DATE: March 3, 2025

TO: Michael S. Gibson
Director, Division of Supervision and Regulation
Board of Governors of the Federal Reserve System

FROM: Michael VanHuysen 
Associate Inspector General for Audits and Evaluations

SUBJECT: OIG Report 2025-SR-B-003: *The Bank Exams Tailored to Risk Process Promotes Risk-Focused Supervision of Community Banking Organizations, but Training Can Be Enhanced*

We have completed our report on the subject evaluation. We conducted this evaluation to assess the Board of Governors of the Federal Reserve System and Federal Reserve Banks' application of the Bank Exams Tailored to Risk process for community banking organizations.

We provided you with a draft of our report for review and comment. In your response, you concur with our recommendations and outline actions that have been or will be taken to address them. We have included your response as appendix B to our report.

We appreciate the cooperation that we received from the Board and the Reserve Banks during our evaluation. Please contact me if you would like to discuss this report or any related issues.

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Introduction

Objective

We assessed the Board of Governors of the Federal Reserve System and Federal Reserve Banks' application of the Bank Exams Tailored to Risk (BETR) process for community banking organizations (CBOs). The scope of our evaluation included full-scope examinations led by the Federal Reserve Bank of New York (FRB New York), the Federal Reserve Bank of Kansas City (FRB Kansas City), and the Federal Reserve Bank of San Francisco (FRB San Francisco) from January 1, 2022, through December 31, 2023. As part of our evaluation, we reviewed documentation regarding the use of BETR to assess credit and liquidity risks in 18 examinations led by the selected Reserve Banks. Appendix A describes our scope and methodology in greater detail.

Background

The Board and Reserve Banks' Role in Supervision

The Board plays a significant role in supervising and regulating financial institutions. Through its oversight, the Board seeks to ensure that the institutions under its supervisory authority operate in a safe and sound manner and comply with all applicable federal laws and regulations. The Board delegates to each Reserve Bank the authority to supervise certain financial institutions located within the Reserve Bank's district. As part of their supervision of these financial institutions, the Reserve Banks perform examinations to assess the safety and soundness of the institutions and assign ratings.¹ As a result of these examinations, the Reserve Banks may downgrade an institution's ratings or issue supervisory actions, including matters requiring attention (MRAs), matters requiring immediate attention (MRIAs), and enforcement actions.²

The Board's Division of Supervision and Regulation (S&R) oversees the Reserve Banks in executing their supervisory responsibilities and issues supervisory policy and guidance to help the Reserve Banks follow the Board's expectations. S&R groups its supervisory activities into multiple portfolios that are generally based on the institution's total asset size. The CBO portfolio includes domestic institutions with less than \$10 billion in total consolidated assets.

¹ Under current supervisory guidance, Reserve Bank examination staff assign each institution a composite rating based on an evaluation and rating of six essential components of the institution's financial condition and operations: adequacy of capital, quality of assets, capability of management, quality and level of earnings, adequacy of liquidity, and sensitivity to market risk. This system is informally referred to as the CAMELS rating system.

² MRAs are matters that the Board expects a banking organization to address over a reasonable period of time. MRIAs are matters of significant importance and urgency that the Board requires banking organizations to address immediately. By law, the Board may issue formal enforcement actions against supervised financial institutions for violations of laws, rules, or regulations; unsafe or unsound practices; violations of final orders; and violations of conditions imposed in writing. Alternatively, the Board may use a variety of informal enforcement tools to address less severe issues, such as deficiencies that are relatively small in number, have a less immediate effect on the safety and soundness of the institution, and can be corrected by management.

The BETR Process

In June 2019, the Board implemented the BETR process to facilitate risk-focused supervision. BETR helps examination staff³ determine the scope and supervisory resources for safety-and-soundness examinations of CBOs.⁴ The BETR process combines metrics with examiner judgment to classify the levels of risk at a state member bank⁵ within individual risk dimensions, known as *risk stripes*.⁶

BETR comprises models for 10 risk stripes: 6 financial risk stripes (capital, earnings, liquidity, credit, investment securities, interest rate risk) and 4 nonfinancial risk stripes (management, operational, fiduciary, Bank Secrecy Act).⁷

BETR consists of three interrelated components:

- **Risk assessments:** Models use forward-looking metrics to assign a risk classification (*low*, *moderate*, or *high*) to institutions by risk stripe. If examination staff observe indicators that suggest the risk is higher or lower, they should override the BETR-suggested risk classification. Examination staff must detail their rationale for any overrides in the examination workpapers.⁸
- **Risk-aligned examination hours:** Each risk classification has a range of suggested hours for planning upcoming examinations, although examination staff may adjust the actual hours if needed.⁹ Examination staff must explain any *material variance*, which is a variance of 10 percent or more between the aggregate BETR-suggested hours and the total actual examination hours.¹⁰
- **Risk-aligned procedures:** Each risk classification has tailored procedures and, if applicable, transaction testing. Examination staff may add, remove, or customize procedures to reflect the risk profile of the institution.

³ For the purposes of this report, *examination staff* refers to examiners, examiners-in-charge, risk specialists, and central points of contact.

⁴ BETR's primary objectives are to identify an institution's low-risk activities and apply appropriately streamlined examination work programs to those areas, identify an institution's high-risk activities and target them for enhanced supervisory attention, and implement examination work programs of average intensity for an institution's moderate-risk activities.

⁵ A *state member bank* is a depository institution that is chartered as a bank by a state and is a member of the Federal Reserve System.

⁶ BETR began as a proof of concept in 2015 called the Outlier Project. This effort was later renamed the BETR Project. In June 2019, the Board formalized BETR by issuing Supervision and Regulation Letter 19-9, *Bank Exams Tailored to Risk*, which outlines the objectives and implementation of the BETR process for determining the scope of supervisory work performed in safety-and-soundness examinations of community and regional state member banks.

⁷ An additional nonfinancial risk stripe (information technology/cybersecurity) is currently under development.

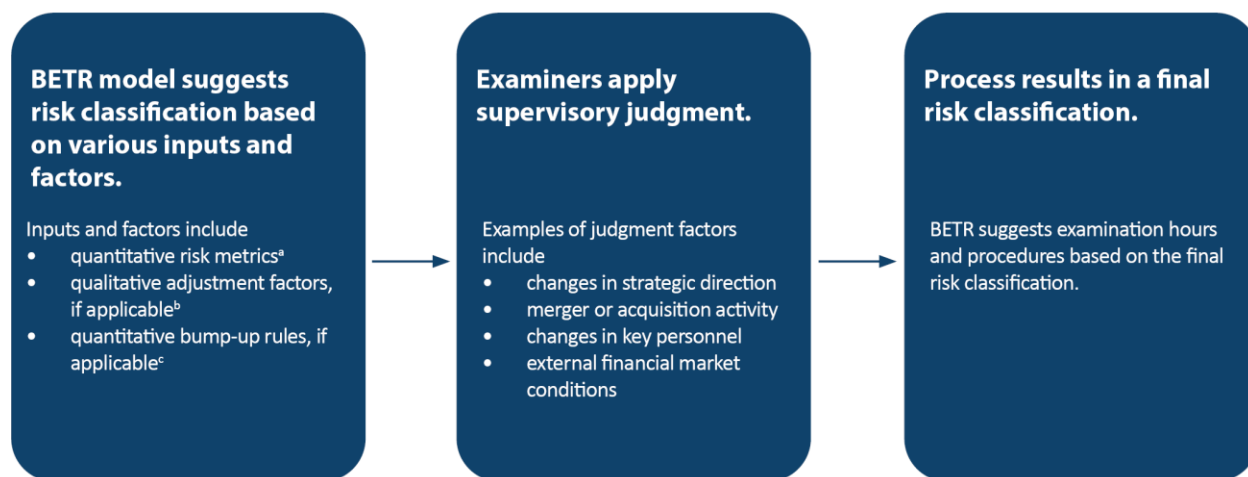
⁸ Examination staff in the selected Reserve Banks indicated that a supervisor must approve an override.

⁹ In addition to risk classifications, other factors may inform BETR-suggested examination hours. For example, the examination hours for credit risk vary based on the size of an institution's loan and lease portfolio.

¹⁰ Examination staff are not required to explain variances in hours for individual risk stripes. Explanations must be provided when there is a material variance in aggregate examination hours.

The figure describes the BETR process.

Figure. The BETR Process



Source: OIG analysis of Federal Reserve System–provided documentation.

^aQuantitative risk metrics are factors used to assess the level of risk at an institution.

^bQualitative adjustment factors are automatic increases to the risk classification proposed by the quantitative risk metrics based on an institution meeting a certain criterion. The BETR Program may implement adjustment factors for a variety of reasons, such as limited data. The BETR Program develops adjustment factors based on business line and subject-matter expert feedback concerning the qualitative factors not captured by the quantitative model, ensuring minimum risk classifications regardless of initial quantitative risk classification results.

^cFollowing model implementation, quantitative bump-up rules exist to automatically increase the risk classification if an institution meets the threshold for the bump-up rule. The Board may add bump-up rules in response to market conditions or based on lessons learned.

The BETR models do not account for qualitative factors, including those associated with unique business models or novel activities.¹¹ However, examination staff can apply supervisory judgment and adjust the BETR-suggested risk classification to account for risks created by these factors.

In October 2020, the Federal Reserve System established the BETR Program, which consists of the BETR Metrics Office and the BETR Program Office, to oversee different aspects of BETR. The BETR Metrics Office oversees model development and enhancement of metrics, among other responsibilities, and the BETR Program Office oversees procedure development and implementation, ongoing procedure maintenance, and continuous improvement activities. The BETR Program revises the models and procedures as economic conditions or model performance warrant. In addition, the BETR Program may adjust the models and procedures to prioritize changing economic risks.

¹¹ A financial institution may have a unique business model because of its financial innovation, expertise, or other product-market strategies that cannot be replicated by competitors, among other factors. Novel activities conducted by financial institutions may include (1) complex, technology-driven partnerships with nonbanks to provide banking services; (2) crypto-asset-related activities; (3) projects that use distributed ledger technology with the potential for a significant effect on the financial system; and (4) concentrated provisions of banking services to crypto-asset-related entities and fintechs.



Finding 1: The BETR Process Promotes Tailored Supervision of CBOs

We found that examination staff in the selected Reserve Banks tailored the BETR-suggested risk classifications, examination hours, and procedures to supervised institutions. This approach aligns with the *Commercial Bank Examination Manual* (CBEM), which states that examiners should tailor supervisory activities to an institution’s condition, risk profile, and unique characteristics. Further, the Board encourages examination staff to apply supervisory judgment during the BETR process. By allowing examination staff to tailor their supervisory activities, the BETR process promotes risk-focused supervision and effective resource allocation.

Examination Staff Tailored the BETR-Suggested Risk Classifications, Examination Hours, and Procedures to Supervised Institutions

We selected 18 examinations and found that examination staff adjusted the BETR-suggested risk classifications, examination hours, and procedures to reflect the risk profiles and unique characteristics of supervised institutions.

Risk Classifications

During our scope period, examination staff in the selected Reserve Banks increased the BETR-suggested risk classifications for credit in 24 percent of examinations.¹² Examination staff frequently indicated that they increased the risk classifications for credit because supervised institutions had agricultural or commercial real estate (CRE) loan concentrations.¹³ Additionally, examination staff increased the BETR-suggested risk classifications for liquidity in 14 percent of examinations, frequently citing rising interest rates.¹⁴

Interviewees across the three Reserve Banks indicated that reasons for overriding the BETR-suggested risk classifications included an examiner’s institutional knowledge, the maturity of an institution’s risk management, risks associated with an institution’s unique business model, and other qualitative factors that the BETR models do not reflect. Further, in our review of 18 examinations from the three Reserve

¹² In 2022, the Board instructed CBO examination staff to assign a final risk classification of *moderate* or *high* to certain institutions with a concentration in CRE or commercial land development loans. These instructions may have affected how infrequently examination staff overrode the credit risk stripe during our scope period. Examination staff in the selected Reserve Banks decreased the BETR-suggested risk classifications for credit in 4 percent of examinations during our scope period.

¹³ Concentrations of credit exposures add a dimension of risk that compounds the risk inherent in individual loans. For example, CRE concentrations may make institutions more vulnerable to cyclical CRE markets. In addition, agricultural concentrations may make institutions more vulnerable to the volatility in agricultural commodity prices, farmland values, and farm production costs.

¹⁴ Among other risks, rising interest rates can increase an institution’s unrealized losses on their investment holdings, which can cause a decline in liquidity.

Banks, we found that a low-risk classification did not appear to affect examination staff's willingness to issue MRAs, MRIAs, or CAMELS ratings downgrades.

Examination Hours

Examination staff frequently deviated from BETR-suggested examination hours for the credit and liquidity risk stripes. Specifically, material variances between the BETR-suggested examination hours and the actual examination hours for the credit and liquidity risk stripes generally occurred in half or more of the in-scope examinations led by the selected Reserve Banks.¹⁵

Interviewees stated that FRB San Francisco examination staff frequently exceeded BETR-suggested examination hours for some risk stripes, including credit, because of the unique and complex institutions in FRB San Francisco's CBO portfolio. Further, an interviewee noted that FRB San Francisco examination staff often needed additional hours for the credit risk stripe because of the loan makeup of the institutions in the Reserve Bank's portfolio, which includes institutions engaged in novel activities. Another interviewee noted that FRB San Francisco's portfolio includes institutions with high CRE concentrations.

We also found that some examination teams deviated from the BETR-suggested hours based on the examination staff's experience level. For example, FRB Kansas City frequently cited experienced examination staff as a reason for using fewer than the aggregate BETR-suggested hours.

Procedures

Examination staff tailored examination procedures to better align with the risks of supervised institutions. Specifically, examination staff indicated that they modified examination procedures based on an institution's risk profile and their supervisory judgment. For example, one interviewee stated that they created customized examination procedures because the BETR examination procedures were not suited to an institution with a unique business model. Another interviewee mentioned that they sometimes create customized examination procedures because they know which areas to review in greater depth based on their experience. Further, the interviewee noted that they will include certain areas for one examination and then focus on different areas in the subsequent examination to ensure that even low-risk areas are being examined in more depth every few examination cycles.

The Board Encourages Examination Staff to Apply Supervisory Judgment During the BETR Process

The CBEM states that the risk-focused supervision process of CBOs aims to align resource requirements for examinations with the risks inherent in the institution's activities. In addition, the manual notes that supervisory judgment is a key element in effectively determining the initial scope of state member bank examinations. The CBEM also states that examiners should tailor supervisory activities to an institution's condition, risk profile, and unique characteristics.

¹⁵ Our scope included full-scope examinations led by our selected Reserve Banks from January 1, 2022, through December 31, 2023.

The Board encourages examination staff to apply supervisory judgment during the BETR process. According to Board guidance, when examination staff are aware of factors indicating that an alternative risk classification would be more appropriate, they should exercise supervisory judgment and adjust the risk classification during the scoping process and then record their rationale in the examination scoping tool. Further, the System has emphasized in its training that examination staff should override the BETR-suggested risk classification if they observe risk indicators that suggest the risk is higher than predicted.

Examination staff largely reported that they do not receive pushback when deviating from the BETR-suggested risk classifications and use as much time as necessary to complete examination work. In fact, only 2 of the 16 examination staff we interviewed felt pressure to adhere to the BETR-suggested risk classifications; the remaining interviewees indicated that they felt no pressure. These two interviewees indicated that pressure is more likely when suggesting to lower the BETR-suggested risk classification; one of them noted that their Reserve Bank has an informal policy to not lower the risk classifications because of the composition and complexity of the institutions in its portfolio. Some interviewees noted that when BETR was first implemented, there was pressure to adhere to the BETR-suggested risk classifications but indicated that was no longer the case. Further, only 1 of the 16 examination staff reported feeling pressure to adhere to the BETR-suggested examination hours; the remaining interviewees indicated that there was no pressure.

By allowing examination staff to tailor supervisory activities to an institution's condition, risk profile, and unique characteristics, the BETR process promotes risk-focused supervision. Further, this flexibility promotes effective resource allocation by enabling Reserve Banks to allocate examination resources based on an institution's risk profile.



Finding 2: The Board Can Enhance Training on Certain Aspects of the BETR Process and Models

We found that some examination staff expressed interest in increasing their understanding of the BETR process and models. According to the U.S. Government Accountability Office's *Standards for Internal Control in the Federal Government*, training aimed at developing and retaining employees' knowledge, skills, and abilities is key to helping an organization achieve its objectives. We attribute examination staff's desire for additional information on the BETR process and models to insufficient training on BETR and a lack of awareness about available resources. We believe that conducting additional training on the BETR process and models and reinforcing the training resources and guidance materials available to examination staff will enhance their ability to use BETR to scope examinations and will increase the effectiveness of the BETR process.

Examination Staff Indicated That Additional Information on the BETR Process, Models, and Bump-Up Rules Would Be Helpful

We found that some examination staff expressed interest in increasing their understanding of the BETR process and models. Specifically, multiple examination staff we interviewed stated that having additional information on the BETR process, the models' risk metrics, or the bump-up rules would be valuable. Some individuals noted the potential benefit of expanded training on these topics. For example, an interviewee noted that more education and training on the BETR models' risk metrics, including the metrics' sources and the rationale for using specific risk metrics, would be helpful.

The BETR Program Provides Training and Resources to Examination Staff

According to the U.S. Government Accountability Office's *Standards for Internal Control in the Federal Government*, training aimed at developing and retaining employees' knowledge, skills, and abilities is key to helping an organization achieve its objectives.

The BETR Program primarily provides training for examination staff through Rapid Response sessions.¹⁶ Many of these sessions are mandatory for CBO examination staff. According to BETR Program documentation, these trainings are a key communication channel to inform examination staff on the

¹⁶ Rapid Response sessions are virtual trainings that communicate emerging issues, policy guidance, and new initiatives consistently and quickly to System supervision staff. From 2019 through 2024, the System held seven Rapid Response sessions on various aspects of BETR for CBOs. Before formalizing BETR in June 2019, the System held seven Rapid Response sessions from 2016 through 2018, including sessions that focused on the financial risk stripes.

implementation of recently developed BETR models and procedures.¹⁷ In addition, the BETR Program maintains a SharePoint site that is accessible to all System supervision staff and contains links to guidance and resources on BETR, including a summary document that describes the model risk metrics, adjustment factors, and bump-up rules for each risk stripe.

Examination Staff Provided Mixed Feedback on Existing Training and Seemed Unaware of Some BETR Resources

We attribute examination staff's desire for additional information on the BETR process and models to insufficient training on BETR and a lack of awareness about available resources. When asked about the Rapid Response sessions, examination staff provided mixed feedback. Some examination staff stated that the trainings were sufficient, while others identified areas for improvement. For example, one interviewee stated that examination staff learn how to scope an examination through on-the-job training and that the Rapid Response sessions could never achieve all the learning objectives related to BETR. In addition, another interviewee noted that the current training format may be inefficient for new examination staff given that they would have to watch all the prior Rapid Response sessions to understand BETR. Further, some examination staff could not recall the Rapid Response sessions or were unsure if they had taken these trainings.

In addition, when asked about the existing guidance on BETR, some examination staff referred to the Supervision and Regulation Letter that formalized BETR or to internal Board or Reserve Bank guidance. None of the examination staff cited as a BETR resource the summary document describing the model risk metrics, adjustment factors, and bump-up rules for each risk stripe. These key components of BETR can change over time as the BETR Program reassesses and redevelops the BETR models.¹⁸ For example, the BETR Metrics Office modified the model for the liquidity risk stripe in 2019 to focus on different risk metrics. In addition, the Board may institute bump-up rules or other changes to BETR in response to economic conditions. A BETR Program Office official stated that beginning in 2025, the program office will review the summary document quarterly and update it as changes occur.

Enhancing Training and Reinforcing Resources Could Increase the Effectiveness of the BETR Process

While the BETR Program has provided resources and training on the BETR process and models, we believe that examination staff's statements regarding their understanding of the BETR process and models and their feedback on the Rapid Response sessions indicate a need for training that is more interactive than

¹⁷ In 2023, the System held a Rapid Response session to inform examination staff that the BETR Program had implemented adjustment factors to the liquidity, investment securities, and capital models in response to shocks to the banking sector.

¹⁸ The BETR Program's original goal was to redevelop the models every 3 years. While many of the BETR models have yet to be redeveloped, the BETR Program plans to redevelop all the financial risk stripe models and some of the nonfinancial risk stripe models by 2026.

the Rapid Response sessions. We believe that more in-depth, interactive training will increase examination staff's understanding of BETR. In addition, in our opinion, conducting additional training on these topics and reinforcing the training resources and guidance materials available to examination staff will enhance their ability to use BETR to scope examinations and increase the effectiveness of the BETR process.

Recommendations

We recommend that the director of S&R

1. Develop training for examination staff that
 - a. provides an overview of the BETR model risk metrics, adjustment factors, and bump-up rules.
 - b. provides an overview of the process for using BETR to scope an examination.
 - c. reinforces the resources and guidance materials available to help examination staff understand these topics.
2. Establish a process to periodically assess the need for additional training as the BETR Program redevelops the models and implements new adjustment factors and bump-up rules.

Management Response

In response to our draft report, the director of S&R concurs with our recommendations. To address recommendation 1, the response states that by the end of the second quarter of 2026, the Board will implement a required training module on BETR within the Examiner Commissioning Program. This interactive module will include practice exercises and learning assessments and will cover the BETR model risk metrics, adjustment factors, and bump-up rules as well as expectations for examiner judgment.

In addition, the response states that by the end of the fourth quarter of 2026, the Board will implement BETR training for commissioned examiners, which will feature interactive elements. Examiners will be required to complete this training every 2 years. The training will include an overview of the BETR program, a summary of BETR metrics and model limitations, information on models that have been redeveloped or enhanced, and a review of BETR resources.

To address recommendation 2, the response states that by the end of the third quarter of 2025, the Board will produce a quarterly report on any identified training gaps and plans for addressing those gaps. Further, System staff will conduct immediate ad hoc training when the BETR models are updated or modified and when banking conditions and BETR model performance change. System staff will also offer ad hoc training based on the results of annual reviews of the BETR process.

OIG Comment

The planned actions described by the Board appear to be responsive to our recommendations. We will follow up to ensure that the recommendations are fully addressed.



Matter for Management Consideration

Of the 18 examinations we reviewed, 5 examinations pertained to institutions with unique business models. We did not observe any issues with examination staff using the BETR process for these institutions because examination staff appeared to apply supervisory judgment in evaluating the BETR-suggested risk classifications. In these 5 examinations, examination staff believed that the BETR-suggested risk classifications for certain risk stripes did not reflect the risks associated with the institutions' unique business models. Because examination staff did not agree with the BETR-suggested risk classifications, they assigned higher risk classifications.

Multiple examination staff noted the importance of exercising judgment when using BETR to scope examinations for institutions with unique business models and novel activities, because the BETR models cannot account for risks at such institutions. For example, one interviewee noted that they have observed a pattern of having to override the BETR-suggested risk classifications when they have institutional knowledge that BETR cannot capture, such as insights related to an institution's unique business model. Another interviewee stated that they had to perform unique analyses and make their own assessment because the BETR examination procedures are not designed for unique institutions.

Some examination staff stated that guidance on how to use BETR when scoping examinations for institutions with unique business models would be helpful. For example, an interviewee stated that guidance on using BETR for institutions with unique business models could be helpful if it is not too prescriptive and allows examination staff to exercise judgment.

The Board's existing guidance generally does not include information on how to use the BETR process for institutions with unique business models or novel activities. Specifically, the only reference to unique business models or novel activities is in the BETR procedures for the operational risk stripe, which instruct examination staff to consider whether an institution is engaged in novel activities.¹⁹

We acknowledge that BETR is intended to promote consistency across examinations for similar institutions of similar risk characteristics and is not intended to account for every risk that an institution may face. However, institutions with unique business models or novel activities may be exposed to elevated levels of risks. For example, in 2023 our office found that unique business models, among other factors, contributed to the failure of Silicon Valley Bank and the voluntary liquidation of Silvergate Bank.²⁰

The risks associated with unique business models and novel activities heighten the importance of applying supervisory judgment to evaluate institutions engaged in these activities. Accordingly, we believe the Board should consider developing guidance on how to use BETR to scope examinations for institutions with unique business models and novel activities. In addition, we suggest that the Board consider establishing a process to periodically update the guidance to reflect evolving insights as

¹⁹ The System held a Rapid Response session in May 2023 to provide an overview of the BETR model and examination procedures for the operational risk stripe. The training materials from this Rapid Response session list crypto-asset-related activities, an example of a novel activity, as a supplemental area of review in the examination procedures section.

²⁰ Office of Inspector General, *Material Loss Review of Silicon Valley Bank*, [OIG Report 2023-SR-B-013](#), September 25, 2023; Office of Inspector General, *Review of the Supervision of Silvergate Bank*, [OIG Report 2023-SR-B-014R](#), September 27, 2023.

institutions engage in new business models or activities. Guidance on using BETR for institutions with unique business models or novel activities could help examination staff better exercise their judgment when determining whether to override the BETR-suggested risk classifications.



Appendix A: Scope and Methodology

We initiated this evaluation to assess the Board and Reserve Banks' application of the BETR process for CBOs. The scope of our evaluation included the use of BETR to assess credit and liquidity risks in full-scope examinations led by FRB New York, FRB Kansas City, and FRB San Francisco from January 1, 2022, through December 31, 2023. Our scope did not include other BETR risk stripes or BETR model validation and reliability.

To accomplish our objective, we reviewed and analyzed relevant policies, procedures, guidance, training materials, and other relevant documentation pertaining to the BETR process. We also reviewed documentation regarding the use of BETR in 18 examinations led by the selected Reserve Banks, including examination reports and workpapers. In addition, we analyzed data on overrides of the BETR-suggested risk classifications and on the BETR-suggested and actual examination hours for the BETR credit and liquidity risk stripes in examinations led by the selected Reserve Banks during our scope period.

To obtain perspectives on the BETR process, we interviewed Board and Reserve Bank officials and staff, including

- Board officials and staff responsible for overseeing the supervision of or analyzing risks to financial institutions
- Board staff responsible for monitoring the use of BETR
- Reserve Bank officials and staff responsible for overseeing BETR
- examination staff associated with our 18 selected examinations
- staff responsible for scheduling examinations in each of the selected Reserve Banks

Our findings cannot be projected across all BETR risk stripes or Reserve Banks. When selecting Reserve Banks, we considered factors such as the number of CBOs in the Reserve Bank's portfolio, average override rate, average number of hours per examination, and whether the Reserve Bank's portfolio had risks related to agricultural or CRE loan concentrations.

We conducted this evaluation in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation*. We conducted our work from February 2024 through January 2025.

Appendix B: Management Response



BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, DC 20551

January 31, 2025

Mr. Michael VanHuysen
Associate Inspector General for Audits and Evaluations
Office of Inspector General
Board of Governors of the Federal Reserve System
Washington, DC 20551

Dear Mr. VanHuysen,

Thank you for the report issued on January 16, 2025, *The Bank Exams Tailored to Risk Process Promotes Risk-Focused Supervision of Community Banking Organizations, but Training Can Be Enhanced*, prepared by the Office of Inspector General (OIG).

The report described the OIG's evaluation of the Federal Reserve's application of the Bank Exams Tailored to Risk (BETR) process for the supervision of community banking organizations. The OIG report concluded that the BETR process promotes risk-focused supervision and effective resource allocation. However, there were two recommendations and one matter for management consideration.

Below are responses from the Division of Supervision and Regulation (Board S&R) on these recommendations and the matter for management consideration.

Recommendation 1: *Develop training for examination staff that*

- a) provides an overview of the BETR model risk metrics, adjustment factors, and bump-up rules.*
- b) provides an overview of the process for using BETR to scope an examination.*
- c) reinforces the resources and guidance materials available to help examination staff understand these topics.*

Management Response: Board S&R agrees with the recommendation to provide additional examiner training to enhance examiners' understanding on the use of the BETR process. Board S&R proposes a two-prong approach to enhance training by:

1. Enhancements to the Examiner Commissioning Program (ECP)

Board S&R propose making BETR training a required module within the ECP, which would be completed before examiner commissioning. This interactive module will include practice exercises and learning assessments. The ECP module will provide new examiners with a strong foundation related to scoping examinations, as well as the use and limitations of BETR risk tiers. The expected completion date for the development and implementation of this ECP module is June 30, 2026. The module would cover the following components:

- metrics
- adjustments and bump-up rules
- deep dives into each BETR model
- metric justification and predictive accuracy
- expectations for examiner judgment

This training will also address the OIG's item for management consideration by incorporating information related to scoping examination activities for institutions with unique business models.

2. Ongoing Training for Commissioned Examiners

Board S&R propose developing BETR training for commissioned examiners that will be distributed via a learning bundle. Commissioned examiners will be required to complete this training every two years. The expected completion date for the ongoing training for commissioned examiners is December 31, 2026. The training will feature interactive elements and cover the following:

- an overview of the BETR program, including program objectives and examiner expectations for scoping, particularly when evaluating firms with unique business models
- a summary of BETR metrics and model limitations
- a focus on models that have been redeveloped or enhanced in the past two years
- a review of BETR learnings resources and program documentation

Recommendation 2: *Establish a process to periodically assess the need for additional training as the BETR Program redevelops the models and implements new adjustment factors and bump-up rules.*

Management Response: Board S&R concurs with the recommendation to establish a process to assess the need to update existing training material, as appropriate. If necessary, System staff will conduct immediate ad-hoc training as conditions require based on the following:

- model updates or modifications (including adjustments to the bump-up rules for assigning the risk tiers of supervised institutions)
- changes in banking conditions and model performance, as well as results from

override analysis

- annual holistic review of the BETR process
- feedback from BETR program liaisons
- changes to examination platforms used for risk tiering and scoping examinations

The process will include a quarterly report to the BETR Council on any identified training gaps and plans for addressing those gaps based on the assessment areas described above. The expected completion date for establishing and documenting this process to periodically assess ongoing training is September 30, 2025.

Matter for Management Consideration: . . . *we believe the Board should consider developing guidance on how to use BETR to scope examinations for institutions with unique business models and novel activities. In addition, we suggest that the Board consider establishing a process to periodically update the guidance to reflect evolving insights as institutions engage in new business models or activities. Guidance on using BETR for institutions with unique business models or novel activities could help examination staff better exercise their judgment when determining whether to override the BETR-suggested risk classifications.*

Management Response: As mentioned in the report, in the BETR procedures for the “operational and legal risk” stripe, examination staff are instructed to consider whether an institution is engaged in novel activities. Training on these new procedures was conducted on August 22, 2024, through a mandatory Rapid Response. If novel activities are identified, the exam team are to consult with the Novel Activities Supervision Program.

Board S&R plans to address this matter for management consideration by expanding training on the use of BETR for supervised institutions with unique business models. This training will be addressed as part of the training enhancements outlined in the response to recommendation 1. In developing this training, System staff will ensure that BETR guidance will be updated, as appropriate.

We value your objective and independent viewpoints and appreciate the professionalism demonstrated by all OIG personnel throughout this review process. We look forward to continuing to work with your office in the future.

Regards,



Michael S. Gibson
Director
Division of Supervision and Regulation



Abbreviations

BETR	Bank Exams Tailored to Risk
CBEM	<i>Commercial Bank Examination Manual</i>
CBO	community banking organization
CRE	commercial real estate
FRB Kansas City	Federal Reserve Bank of Kansas City
FRB New York	Federal Reserve Bank of New York
FRB San Francisco	Federal Reserve Bank of San Francisco
MRA	matter requiring attention
MRIA	matter requiring immediate attention
S&R	Division of Supervision and Regulation

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