

an external auditing program performed by an independent public accountant.

Appendix A—Definitions

Appropriate supervisory office. The regional or district office of the institution's primary federal banking agency which is responsible for supervising the institution, or, in the case of an institution that is part of a group of related insured institutions, the regional or district office of the institution's federal banking agency which is responsible for monitoring the group. If the institution is a subsidiary of a holding company, the term "appropriate supervisory office" also includes the federal banking agency responsible for supervising the holding company. In addition, if the institution is state-chartered, the term "appropriate supervisory office" includes the appropriate state bank or savings association regulatory authority.

Audit. An examination of the financial statements, accounting records, and other supporting evidence of an institution performed by an independent certified or licensed public accountant in accordance with generally accepted auditing standards (GAAS) and of sufficient scope to enable the independent public accountant to express an opinion on the institution's financial statements as to their presentation in accordance with generally accepted accounting principles (GAAP).

Audit Committee. A committee of the board of directors whose members should, to the extent possible, be knowledgeable about accounting and auditing. The committee should be responsible for reviewing and approving the institution's internal and external auditing programs or recommending adoption of these programs to the full board. Both the internal auditor and the independent public accountant should have unrestricted access to the audit committee without the need for any prior management knowledge or approval. Other duties of the audit committee may include reviewing the independence of the independent public accountant annually, consulting with management when management seeks a second opinion on an accounting issue, and overseeing the quarterly regulatory reporting process. The audit committee should report its findings periodically to the full board of directors.

Directors' Examination. An engagement performed by an independent third party that has been authorized by the institution's board of directors and is required by state law. (A directors' examination is called an

"engagement audit" or "operational audit." Nevertheless, it is often not performed in accordance with GAAS nor do widely accepted national standards exist for its performance.)

External Auditing Program. The testing and evaluation of risk areas of an institution's business by an independent public accountant sufficient to enable the accountant to express an opinion on the financial statements or balance sheet. Under professional standards, this engagement should be performed in accordance with GAAS. Alternatively, an independent public accountant may attest to management's assertion concerning the effectiveness of the institution's internal control over financial reporting. Under professional standards, the independent public accountant is expected to perform this attestation engagement in accordance with the generally accepted standards for attestation engagements (GASAE).

Financial Statements. The statements of financial position (balance sheet), income, cash flows, and changes in equity together with related notes.

Independent Public Accountant. An accountant who is independent of the institution and registered or licensed to practice as a public accountant, and is in good standing, under the laws of the state or other political subdivision of the United States in which the home office of the institution is located. No certified public accountant or public accountant will be recognized as independent who is not in fact independent. The independent public accountant also should comply with the American Institute of Certified Public Accountants' (AICPA) *Code of Professional Conduct* and any related guidance adopted by the banking agencies.

Internal auditing. An independent assessment function established within an institution to examine and evaluate its system of internal control and the efficiency with which the various units of the institution are carrying out their assigned tasks. The objective of internal auditing is to assist the management and directors of the institution in the effective discharge of their responsibilities. To this end, internal auditing furnishes management with analyses, appraisals, recommendations, counsel, and information concerning the activities reviewed.

Outside Directors. Members of an institution's board of directors who are not officers, employees, or principal stockholders of the institution, its subsidiaries, or its affiliates, and do not have any material business dealings with the institution, its subsidiaries, or its affiliates.

Regulatory Reports. These reports are the Reports of Condition and Income (Call Reports) for banks and Thrift Financial Reports (TFRs) for savings associations.

Report on the Balance Sheet. An examination of an institution's balance sheet performed and reported on by an independent public accountant in accordance with GAAS and of sufficient scope to enable the independent public accountant to express an opinion on the fairness of the balance sheet presentation in accordance with GAAP.

Risk Areas. Those particular activities of an institution that expose it to greater potential losses if problems exist and go undetected. The areas with the highest financial reporting risk in most institutions generally are their lending and investment securities activities.

Dated: February 5, 1998.

Joe M. Cleaver,

Executive Secretary, Federal Financial Institutions Examination Council.

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FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

Uniform Interagency Trust Rating System

AGENCY: Federal Financial Institutions Examination Council.

ACTION: Notice and request for comment.

SUMMARY: The Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) (collectively referred to as the federal supervisory agencies), under the auspices of the Federal Financial Institutions Examination Council (FFIEC) request comment on proposed changes to the Uniform Interagency Trust Rating System (UITRS), commonly referred to as the trust rating system. The proposed revisions update the rating system to reflect changes that have occurred in the fiduciary services industry and in supervisory policies and procedures since the rating system was first adopted in 1978. The proposed changes revise the numerical ratings to conform to the language and tone of the Uniform Financial Institution Rating System (UFIRS) rating definitions, commonly referred to as the CAMELS rating system; reformat and clarify the component rating descriptions; reorganize the account administration and conflicts of interest components

into a new component addressing compliance; emphasize the quality of risk management processes in each of the rating components, particularly in the management component; add language in composite rating definitions to parallel the proposed changes in the component rating descriptions; and explicitly identify the risk types that are considered in assigning component ratings. After reviewing public comments, the FFIEC intends to make appropriate additional changes to the revised UITRS, if necessary, and adopt a final trust rating system.

The term "financial institution" refers to those FDIC insured depository institutions whose primary Federal supervisory agency is represented on the FFIEC. Uninsured trust companies that are chartered by the OCC, members of the Federal Reserve System, or subsidiaries of registered bank holding companies or insured depository institutions are also covered by this action.

DATES: Comments must be received by April 20, 1998.

ADDRESSES: Comments should be sent to Joe M. Cleaver, Executive Secretary, Federal Financial Institutions Examination Council, 2100 Pennsylvania Avenue, NW, Suite 200, Washington, D.C. 20037 (Fax number: (202) 634-6556). Comments will be available for public inspection during regular business hours at the above address. Appointments to inspect comments are encouraged and can be arranged by calling the FFIEC at (202) 634-6526.

FOR FURTHER INFORMATION CONTACT:

FRB: William R. Stanley, Supervisory Trust Analyst, Specialized Activities, (202) 452-2744, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Mail Stop 407, 20th and C Streets, NW, Washington, D.C. 20551.

FDIC: John F. Harvey, Trust Review Examiner, (202) 898-6762, Division of Supervision, Federal Deposit Insurance Corporation, Room F2078, 550 17th Street, NW, Washington, D.C. 20429.

OCC: Laurie A. Edlund, National Bank Examiner, (202) 874-3828, Division of Asset Management, Office of the Comptroller of the Currency, 250 E Street, SW, Washington, D.C. 20219.

OTS: Larry A. Clark, Senior Manager, Compliance and Trust Programs, (202) 906-5628, Gary C. Jackson, Program Analyst, (202) 906-5653, Compliance Policy, Office of Thrift Supervision, 1700 G Street, NW, Washington, D.C. 20552.

SUPPLEMENTARY INFORMATION:

Background Information

The UITRS is an internal supervisory examination rating system used by the Federal supervisory agencies for evaluating the administration of fiduciary activities of financial institutions and uninsured trust companies on a uniform basis and for identifying those institutions requiring special supervisory attention. The UITRS was adopted in 1978 by the OCC, FDIC and FRB, and in 1988 by the OTS, and is commonly referred to as the trust rating system. Under the current UITRS, each financial institution or trust company is assigned a composite rating based on an evaluation and rating of six essential components of an institution's fiduciary activities. These components address the following: the capability of management; the adequacy of operations, controls and audits; the management of fiduciary assets; the adequacy of account administration practices; the adequacy of practices relating to self dealing and conflicts of interest; and the quality and level of earnings. Both the composite and component ratings are assigned on a 1 to 5 numerical scale. A 1 indicates the strongest performance and management practices, and the least degree of supervisory concern, while a 5 indicates the weakest performance and management practices and, therefore, the highest degree of supervisory concern.

The composite rating reflects the overall condition of an institution's fiduciary activities. The composite ratings are used by the Federal supervisory agencies to monitor aggregate trends in the overall administration of fiduciary activities.

The UITRS has proven to be an effective means for the Federal supervisory agencies to determine the condition of an institution's fiduciary activities. A number of changes, however, have occurred in the fiduciary industry and in supervisory policies and procedures since the rating system was first adopted. The FFIEC's Task Force on Supervision has reviewed the existing rating system in light of these industry trends. The Task Force has concluded that the current UITRS framework continues to provide an effective vehicle for summarizing conclusions about the condition of an institution's fiduciary activities. As a result, the FFIEC proposes to retain the basic rating framework, and the revised rating system will continue to assign a composite rating based on an evaluation and rating of essential components of an institution's fiduciary activities.

However, the FFIEC proposes certain enhancements to the rating system.

Discussion of Proposed Changes to the Rating System

1. Alignment of UITRS With UFIRS

The FFIEC is proposing changes to revise the definitions of the composite and component ratings to align the UITRS rating definitions with the language and tone of the UFIRS rating definitions. For example, under the current UITRS a composite 3 rated trust department is considered generally adequate, while under the UFIRS a composite 3 rated bank exhibits some degree of supervisory concern. The proposed revision brings the UITRS in line with the language and tone of the UFIRS.

2. Component Reorganization

The FFIEC is proposing the following changes to the UITRS components:

(A) The current Account Administration and Conflicts of Interest components will be eliminated. A new Compliance component will assess an institution's compliance with the terms of governing instruments, applicable laws and regulations, sound fiduciary principles, and internal policies and procedures. The new component will address all areas assessed in the current Account Administration and Conflicts of Interest components. In addition, the new component will address compliance with applicable laws, regulations, and internal policies and procedures on a broader, institution-wide basis.

(B) While fiduciary earnings will be evaluated at all institutions, a rating will only be required for those institutions which are required to file Schedule E of the FFIEC 001 (institutions with more than \$100 million in total trust assets, and all non-deposit trust companies). An earnings rating may or may not be required for non-Schedule E filers, at the option of the Federal supervisory agency. With this proposed change, the FFIEC recognizes that many small institutions offer fiduciary services primarily as a service to their community, with profitability being a secondary consideration.

3. Structure and Format

The FFIEC is proposing to enhance and clarify the component rating descriptions by reformatting each component into three distinct sections: (a) An introductory paragraph discussing in general terms the areas to be considered when rating each component; (b) a bullet-style listing of the specific evaluation factors to be

considered when assigning the component rating; and, (c) a brief qualitative description of the five ratings grades that can be assigned to a particular component.

4. Composite Rating Definitions

The FFIEC is proposing changes in the composite rating definitions to parallel the changes in the component rating descriptions. Under the FFIEC's proposal, the revised composite rating definitions would contain an explicit reference to the quality of overall risk management practices. The basic context of the existing composite rating definitions is being retained. The composite rating would continue to be based on a careful evaluation of an institution's fiduciary management, operational and compliance performance.

5. Risk Management

The FFIEC is proposing that the revised rating system emphasize risk management processes. Changes in the fiduciary services industry have broadened the range of products and services offered and accelerated the pace of transactions. These trends reinforce the importance of institutions having sound risk management processes. Accordingly, the revised rating system would contain language in each of the components emphasizing the consideration of processes to identify, measure, monitor and control risks.

6. Identification of Risk Types

The FFIEC is proposing that the types of risks associated with each of the component ratings be explicitly identified. For example, the proposed rating description for the Operations, Internal Controls, and Audits notes that a primary consideration in assigning the component rating is an assessment of the transaction risk associated with the institution's fiduciary operating systems and internal controls. However, all of the risks affecting fiduciary operations and internal controls, including but not limited to reputation, strategic, and compliance risks would also be considered.

Request for Comments

The FFIEC requests comment on the proposed revisions to the trust rating system ("the proposal"). In addition, the FFIEC invites comments on the following questions:

1. Does the proposal capture the essential risk areas of the fiduciary services industry?
2. Does the proposed management component adequately assess the

quality of the board of directors' and management's oversight regarding its fiduciary responsibility and its ability to identify and manage all areas of risk involved in the exercise of its fiduciary powers?

3. Are there any components which should be added to or deleted from the proposal?

4. Are the definitions for the individual components and the composite numerical ratings in the proposal consistent with the language and tone of the UFIRS definitions?

Text of the Revised Uniform Interagency Trust Rating System

Uniform Interagency Trust Rating System

Introduction

The Uniform Interagency Trust Rating System (UITRS) was adopted on September 21, 1978 by the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve Board (FRB), and in 1988 by the Federal Home Loan Bank Board, predecessor agency to the Office of Thrift Supervision (OTS). Over the years, the UITRS has proven to be an effective internal supervisory tool for evaluating the fiduciary activities of financial institutions on a uniform basis and for identifying those institutions requiring special attention or concern.

A number of changes have occurred in both the banking industry and the Federal supervisory agencies' policies and procedures which have prompted a review and revision of the 1978 rating system. The revisions to the UITRS:

- Realign the UITRS rating definitions to bring them in line with UFIRS;
- Reduce the component rating categories from six to five, combining the Account Administration and Conflicts of Interest components into a new Compliance component;
- Make the earnings rating optional, at the Federal supervisory agency's discretion, for institutions not required to file the FFIEC 001 Schedule E (institutions with total trust assets of more than \$100 million, and all non-deposit trust companies are required to file Schedule E); and
- Explicitly refer to the quality of risk management processes in the management component, and the identification of risk elements within the composite and component rating definitions.

The revisions are intended to promote and complement efficient examination processes. The revisions update the rating system but retain the basic framework of the original rating system.

Consequently, the revised rating system will not result in additional regulatory burden to institutions or require additional policies or processes.

The UITRS considers certain managerial, operational, financial and compliance factors that are common to all institutions with fiduciary activities. Under this system, the supervisory agencies endeavor to ensure that all institutions with fiduciary activities are evaluated in a comprehensive and uniform manner, and that supervisory attention is appropriately focused on those institutions exhibiting weaknesses in their fiduciary operations.

Overview

Under the proposed UITRS, the fiduciary activities of financial institutions are assigned a composite rating based on an evaluation and rating of five essential components of an institution's fiduciary activities. These component factors address the following: the capability of management; the adequacy of operations, controls and audits; the quality and level of earnings; compliance with governing instruments, applicable law, and sound fiduciary principles; and the management of fiduciary assets. Evaluation of the components considers the size and sophistication, the nature and complexity, and the risk profile of the institution's fiduciary activities.

Composite and component ratings are assigned based on a 1 to 5 numerical scale. A 1 is the highest rating and indicates the strongest performance and risk management practices and the least degree of supervisory concern. A 5 is the lowest rating and indicates the weakest performance and risk management practices and, therefore, the highest degree of supervisory concern.

The composite rating generally bears a close relationship to the component ratings assigned. However, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors comprising that component and its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, assignment of a composite rating may incorporate any factor that bears significantly on the overall administration of the financial institution's fiduciary activities. Assigned composite and component ratings are disclosed to the institution's

board of directors and senior management.

The ability of management to respond to changing circumstances and to address the risks that may arise from changing business conditions, or the initiation of new fiduciary activities or products, is an important factor in evaluating an institution's overall fiduciary risk profile and the level of supervisory attention warranted. For this reason, the management component is given special consideration when assigning a composite rating.

The ability of management to identify, measure, monitor, and control the risks of its fiduciary operations is also taken into account when assigning each component rating. It is recognized, however, that appropriate management practices may vary considerably among financial institutions, depending on the size, complexity and risk profiles of their fiduciary activities. For less complex institutions engaged solely in traditional fiduciary activities and whose directors and senior managers are actively involved in the oversight and management of day-to-day operations, relatively basic management systems and controls may be adequate. On the other hand, at more complex institutions, detailed and formal management systems and controls are needed to address a broader range of activities and to provide senior managers and directors with the information they need to supervise day-to-day activities.

All institutions are expected to properly manage their risks. For less complex institutions engaging in less risky activities, detailed or highly formalized management systems and controls are not required to receive strong or satisfactory component or composite ratings.

The following two sections contain the composite rating definitions, and the descriptions and definitions for the five component ratings.

Composite Ratings

Composite ratings are based on a careful evaluation of how an institution conducts its fiduciary activities. The review encompasses the capability of management, the soundness of policies and practices, the quality of service rendered to the public, and the effect of fiduciary activities upon the soundness of the institution. The five key components used to assess an institution's fiduciary activities are: the capability of management; the adequacy of operations, controls and audits; the quality and level of earnings; compliance with governing instruments, applicable law, and sound fiduciary

principles; and the management of fiduciary assets. The rating scale ranges from 1 to 5, with a rating of 1 indicating the strongest performance and risk management practices relative to the size, complexity and risk profile of the institution's fiduciary activities, and the least supervisory concern. A 5 rating indicates the most critically deficient performance and risk management practices relative to the size, complexity, and risk profile of the institution's fiduciary activities, and the greatest supervisory concern. The composite ratings are defined as follows:

Composite 1. Administration of fiduciary activities is sound in every respect and generally all components are rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by management. The institution is in substantial compliance with fiduciary laws and regulations. Risk management practices are strong relative to the size, complexity, and risk profile of the institution's fiduciary activities. Fiduciary activities are conducted in accordance with sound fiduciary principles and give no cause for supervisory concern.

Composite 2. Administration of fiduciary activities is fundamentally sound. Generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within management's capabilities and willingness to correct. Fiduciary activities are conducted in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Composite 3. Administration of fiduciary activities exhibits some degree of supervisory concern in one or more of the component areas. A combination of weaknesses exists that may range from moderate to severe; however, the magnitude of the deficiencies generally does not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Additionally, fiduciary activities may be conducted in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. While problems of relative significance may exist, they are not of such importance as to pose a threat to the trust beneficiaries generally, or to the soundness of the

institution. The institution's fiduciary activities require more than normal supervision and may include formal or informal enforcement actions.

Composite 4. Fiduciary activities generally exhibit unsafe and unsound practices or conditions, resulting in unsatisfactory performance. The problems range from severe to critically deficient and may be centered around inexperienced or inattentive management, weak or dangerous operating practices, or an accumulation of unsatisfactory features of lesser importance. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the size, complexity, and risk profile of fiduciary activities. These problems pose a threat to the account beneficiaries generally and, if left unchecked, could evolve into conditions that could ultimately undermine the public confidence in the institution. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems.

Composite 5. Fiduciary activities are conducted in an extremely unsafe and unsound manner. Administration of fiduciary activities is critically deficient in numerous major respects, with problems resulting from incompetent or neglectful administration, flagrant and/or repeated disregard for laws and regulations, or a willful departure from sound fiduciary principles and practices. The volume and severity of problems are beyond management's ability or willingness to control or correct. Such conditions evidence a flagrant disregard for the interests of the beneficiaries and may pose a serious threat to the soundness of the institution. Continuous close supervisory attention is warranted and may include termination of the institution's fiduciary activities.

Component Ratings

Each of the component rating descriptions is divided into three sections: a narrative description of the component; a list of the principal factors used to evaluate that component; and a description of each numerical rating for that component. Some of the evaluation factors are reiterated under one or more of the other components to reinforce the interrelationship among components. The listing of evaluation factors is in no particular order of importance.

Management. This rating reflects the capability of the board of directors and

management, in their respective roles, to identify, measure, monitor and control the risks of an institution's fiduciary activities. It also reflects their ability to ensure that the institution's fiduciary activities are conducted in a safe and sound manner, and in compliance with applicable laws and regulations. Directors should provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures and practices are established and followed. Senior fiduciary management is responsible for developing and implementing policies, procedures and practices that translate the board's objectives and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's fiduciary activities, management practices may need to address some or all of the following risks: reputation, operating or transaction, strategic, compliance, legal, credit, market, liquidity and other risks. Sound management practices are demonstrated by: active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls that consider the size and complexity of the institution's fiduciary activities; and effective risk monitoring and management information systems. This rating should reflect the board's and management's ability as it applies to all aspects of fiduciary activities in which the institution is involved.

The management rating is based upon an assessment of the capability and performance of management and the board of directors, including, but not limited to, the following evaluation factors:

- The level and quality of oversight and support of fiduciary activities by the board of directors and management, including committee structure and adequate documentation of committee actions.
- The ability of the board of directors and management, in their respective roles, to plan for, and respond to, risks that may arise from changing business conditions or the introduction of new activities or products.
- The adequacy of, and conformance with, appropriate internal policies, practices and controls addressing the operations and risks of significant fiduciary activities.
- The accuracy, timeliness, and effectiveness of management information and risk monitoring systems appropriate for the institution's size, complexity, and fiduciary risk profile.

- Overall level of compliance with laws, regulations, and sound fiduciary principles.

- Responsiveness to recommendations from auditors and regulatory authorities.
- Strategic planning for fiduciary products and services.
- The level of experience and competence of fiduciary management and staff, including issues relating to turnover and succession planning.
- The availability of adequate insurance coverage.
- The availability of competent legal counsel.
- Extent and nature of pending litigation associated with fiduciary activities, and its potential impact on earnings, capital, and the institution's reputation.
- Process for identifying and responding to fiduciary customer complaints.

Ratings.

1. A rating of 1 indicates strong performance by management and the board of directors and strong risk management practices relative to the size, complexity and risk profile of the institution's fiduciary activities. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

2. A rating of 2 indicates satisfactory management and board performance and risk management practices relative to the size, complexity and risk profile of the institution's fiduciary activities. Minor weaknesses may exist, but are not material to the sound administration of fiduciary activities, and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

3. A rating of 3 indicates management and board performance that need improvement or risk management practices that are less than satisfactory given the nature of the institution's fiduciary activities. The capabilities of management or the board of directors may be insufficient for the size, complexity or risk profile of the institution's fiduciary activities. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

4. A rating of 4 indicates deficient management and board performance or risk management practices that are inadequate considering the nature of an institution's fiduciary activities. The level of problems and risk exposure is excessive. Problems and significant

risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to protect the assets of account beneficiaries and to prevent erosion of public confidence in the institution. Replacing or strengthening management or the board may be necessary.

5. A rating of 5 indicates critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution or its administration of fiduciary activities as well as posing a threat to the safety of the assets of account beneficiaries. Replacing or strengthening management or the board of directors is necessary.

Operations, Internal Controls & Auditing. This area encompasses the department's operating systems and internal controls in relation to the volume and character of business conducted. The adequacy of audit coverage must assure the integrity of the financial records, the sufficiency of internal controls, and the adequacy of the compliance process.

The institution's fiduciary operating systems, internal controls, and audit function subject it primarily to transaction and compliance risk; however, other risks including reputation, strategic, and financial may be present. The ability of management to identify, measure, monitor and control these risks is reflected in this rating.

The operations, internal controls and auditing rating is based upon, but not limited to, an assessment of the following evaluation factors:

Operations and Internal Controls, including adequacy of:

- Staff, facilities and operating systems;
- Records, accounting and data processing systems (including controls over systems access and such accounting procedures as aging, investigation and disposition of items in suspense accounts);
- Trading functions and securities lending activities;
- Vault controls and securities movement;
- Segregation of duties;
- Controls over disbursements (checks or electronic) and unissued securities;

- Controls over income processing activities;
- Reconciliation processes (depository, cash, vault, sub-custodians, suspense accounts, etc.);
- Disaster and/or business recovery programs;
- Hold-mail procedures and controls over returned mail; and
- Investigation and proper escheatment of funds in dormant accounts.

Auditing, including the:

- Independence, frequency, quality and scope of the internal and external fiduciary audit function relative to the volume, character and risk profile of the institution's fiduciary activities;
- Volume and/or severity of internal control and audit exceptions and the extent to which these issues are tracked and resolved; and
- Experience and competence of the audit staff.

Ratings.

1. A rating of 1 indicates that operations, internal controls, and audits are strong. All significant risks are consistently and effectively identified, measured, monitored, and controlled.

2. A rating of 2 indicates that while operations, internal controls and audits are satisfactory, modest weaknesses may exist. These weaknesses, however, are not material in nature and, in general, are effectively identified, measured, monitored, and controlled.

3. A rating of 3 indicates that operations, internal controls and/or auditing need improvement. One or more of these areas are less than satisfactory. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

4. A rating of 4 indicates deficient operations, internal controls and/or audits in which one or more of these areas are inadequate or the level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action. Departments with this level of deficiencies may make little provision for audits of any kind or may evidence weak or potentially dangerous operating practices in combination with infrequent or inadequate audits.

5. A rating of 5 indicates critically deficient operations, internal controls and/or audits. Operating practices, with or without audits, pose a serious threat to the safety of assets of fiduciary accounts. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the ability of the institution to continue engaging in fiduciary activities.

Earnings. This area includes an evaluation of the department's profitability and its effect on the financial condition of the institution. The use and adequacy of budgets and earnings projections by functions, product lines and clients are reviewed and evaluated. Risk exposure that may lead to negative earnings is also evaluated.

Earnings are evaluated at all fiduciary examinations. A rating for the earnings component is assigned as follows:

• *Mandatory Rating of Earnings*.

Earnings are rated at every trust examination where the financial institution would, at the time of the examination, be required to file Schedule E (Trust Income Statement) of the FFIEC Annual Report of Trust Assets. Schedule E must be completed by (1) each financial institution with more than \$100 million in Total Trust Assets as reported on Schedule A, and (2) by all non-deposit trust companies, whether or not they report any assets on Schedule A.

• *Optional Rating of Earnings*. If an institution is not required to file Schedule E of the FFIEC Annual Report of Trust Assets, this component may be rated at the option of the examining agency and in accordance with its implementing guidelines.

The earnings rating is based upon, but not limited to, an assessment of the following evaluation factors:

- The level and consistency of profitability, or the lack thereof, generated by the institution's fiduciary activities.
- Dependence upon non-recurring fees and commissions, such as those for court accounts.
- Unusual features regarding the composition of business, fee schedules and effects of charge-offs or compromise actions.
- Accounting practices which may contain unusual practices such as (1) unusual methods of allocating direct and indirect expenses and overhead and (2) methods of allocating fiduciary income and expense where two or more fiduciary institutions within the same holding company family share fiduciary services and/or processing functions.
- Extent of management's use of budgets, projections and other cost analysis procedures.
- Methods used for directors' approval of financial budgets and/or projections.
- Management's attitude toward growth and new business development.
- New business development efforts, including types of business solicited, market potential, advertising, competition, relationships with local

organizations, and an evaluation by management of risk potential inherent in new business areas.

Ratings.

1. A rating of 1 indicates strong earnings. Strong earnings generally mean five consecutive years of profitable net trust operating income, in a volume reflecting the institution's size and type of fiduciary services offered, with indications of continued profitable operations. Earnings and future prospects are sufficient to support the continuation of fiduciary activities without engaging in activities that may result in risks or other factors that would affect the quality and quantity of earnings. In addition, management makes effective use of budgets and cost analysis procedures, such as earnings projections by functions, product lines and clients. Methods used for reporting such information to, as well as obtaining approvals from the board of directors, or a committee thereof, are adequate.

2. A rating of 2 indicates satisfactory earnings. Satisfactory earnings are generally indicated by profitable net trust operating income in three of the past five consecutive years, with indications of continued profitable operations. Management's use of budgets and projections, and other cost analysis procedures, as well as the methods used for directors' approvals of these financial reports, is generally satisfactory for the size and complexity of the institution.

A 2 rating may also be assigned where there are five years of profitable operations (which would normally warrant a 1 rating), if there are indications that management is entering activities with which it is not familiar, or where there may be inordinately high levels of risk present that have not been adequately evaluated. As a result, continuation of profitable operations is questionable.

Optional Rating of Earnings. In instances where the rating of trust earnings is optional under these guidelines and the institution is not generating positive earnings, or where information concerning this area may not be available in a formal manner, a 2 rating may be assigned if management has satisfactorily evaluated the positive effect of offering of fiduciary services to the continued growth of the institution and its overall earnings. However, management should, at a minimum, (a) have a reasonable method for measuring income and expense commensurate with the volume and nature of fiduciary services offered, (b) report the level of profitability or operating losses to the board of directors, or a committee thereof, at least annually, and (c) obtain

approval from the board of directors, or a committee thereof, for offering fiduciary services. In these instances, the board of directors may consider the lack of fiduciary profitability to be a cost of doing business as a full service institution and believe the negative effects of not offering fiduciary services are more significant than the expense of administering those services.

3. A rating of 3 indicates less than satisfactory earnings, which generally means inconsistent or marginally-profitable net trust operating income over the past five consecutive years. A 3 rating may also be assigned when operations are generally unprofitable, even if gross income permits recovery of salary expenses. Over a five year period, however, the department's earnings trend has shown less ability to recover salary expense and projections do not indicate a reversal of this trend. Management may not be making proper use of budgets and projections, and other cost analysis procedures. Earnings accorded this rating need to improve to fully support the institution's fiduciary activities and provide for the associated risks.

Optional Rating of Earnings. In instances where the rating of trust earnings is optional under these guidelines, this rating may be assigned if management has a reasonable method for measuring trust income and expense, but either fails to adequately (a) report the level of profitability or operating losses to the board of directors, or a committee thereof, at least annually, or (b) obtain approval from the board of directors, or a committee thereof, for the offering of the service. While management may have attempted to identify and quantify collateral revenue to be earned by offering fiduciary services, it has decided that these services should be offered as a community service, even if they cannot be operated profitably.

4. A rating of 4 indicates earnings that are deficient, and do not support fiduciary activities. Operating losses, when averaged over the previous five year period, do not generally cover salary or other direct expenses. In general, this would be indicated by unprofitable net trust operating income in the past three consecutive years, with indications of continued unprofitable operations. The five year trend may indicate erratic fluctuations in net income, the development of a significant negative trend, nominal earnings, unsustainable earnings, intermittent losses or a substantial drop in earnings from the previous year. Business volume and prospects suggest a continuation of this trend. Budgets are

either not used or not followed, and there is no accountability for failing to adhere to financial targets. Reporting of earnings information to the board of directors, or a committee thereof, is inadequate, incomplete, or ineffective.

Optional Rating of Earnings. In instances where the rating of trust earnings is optional under these guidelines, this rating may be assigned if management has failed to adequately implement two of the three minimum standards cited under Rating No. 2 above. Management has undertaken little or no effort to identify or quantify the collateral advantages, if any, to the institution from offering fiduciary services.

5. A rating of 5 indicates critically deficient earnings. In general, this means unprofitable net trust operating income in the past five consecutive years, with indications of continued unprofitable operations. A trust department with this rating is experiencing losses that have a significant negative impact on the overall earnings of the institution and that may represent a distinct threat to its viability through the erosion of its capital. Budgeting is likely to be nonexistent and/or unrealistic and ineffective. The board of directors, or a committee thereof, may not be aware of the condition and/or there is no effective method to communicate such matters to the board on a regular basis.

Optional Rating of Earnings. In instances where the rating of trust earnings is optional under these guidelines, this rating may be assigned if management has failed to adequately implement any of the three minimum standards described under Rating No. 2 above.

Compliance. The compliance rating component covers an institution's overall compliance with applicable laws, regulations, accepted standards of fiduciary conduct, governing account instruments and internally established policies and procedures. This component specifically incorporates an assessment of a fiduciary's duty of undivided loyalty and duties associated with account administration.

Risks associated with account administration are virtually unlimited because each account is a separate contractual relationship that contains specific obligations. Risks associated with account administration include: failure to comply with applicable laws, regulations or terms of the governing instrument; inadequate account administration practices; and inexperienced management or inadequately trained staff. Risks associated with a fiduciary's duty of

undivided loyalty generally stem from engaging in self-dealing or other conflict of interest transactions. An institution is subject to compliance risk and strategic risk related to account administration and conflicts of interest activities. The ability of management to identify, measure, monitor and control these risks is reflected in this rating. Policies, procedures and practices pertaining to account administration and conflicts of interest are evaluated in light of the size and character of an institution's fiduciary business.

The compliance rating is based upon, but not limited to, an assessment of the following evaluation factors:

- Applicable federal and state statutes and regulations, including, but not limited to, federal and state fiduciary laws, the Employee Retirement Income Security Act of 1974, federal and state securities laws, state investment standards, state principal and income acts, and state probate codes;
- Terms of governing instruments; and
- Internally established policies and procedures, including, but not limited to, those addressing self-dealing and other conflicts of interest, account administration, and asset (including cash) management.

Ratings.

1. A rating of 1 indicates strong compliance policies, procedures and practices. Policies and procedures covering conflicts of interest and account administration are appropriate for the size and complexity of the business. Accounts are administered in accordance with governing instruments, applicable laws and regulations, sound fiduciary principles, and internal policies and procedures. Any violations are isolated, technical in nature and easily correctable. All significant risks are consistently and effectively identified, measured, monitored and controlled.

2. A rating of 2 indicates fundamentally sound compliance policies, procedures and practices. Account administration may be flawed by modest weaknesses in policies, procedures or practices. Management's practices indicate a determination to minimize the instances of conflicts of interest. Fiduciary activities are conducted in substantial compliance with laws and regulations, and any violations are generally technical in nature. Management corrects violations in a timely manner and without loss to fiduciary accounts. Significant risks are effectively identified, measured, monitored, and controlled.

3. A rating of 3 indicates compliance practices that are less than satisfactory.

Policies, procedures and controls have not proven effective and may require strengthening. Fiduciary activities may be in substantial noncompliance with laws, regulations or governing instruments; however, losses are minimal. Management may have the ability to effect compliance; however, the number of violations that exist, or failure to correct prior violations, are indications that management has not devoted sufficient time and attention to its compliance responsibilities. Risk management practices generally need improvement.

4. A rating of 4 indicates institutions with deficient compliance practices. Account administration is notably deficient. The institution makes little or no effort to minimize potential conflicts or refrain from self dealing, and is confronted with a considerable number of potential or actual conflicts. Numerous substantive and technical violations of laws and regulations exist and many may remain uncorrected from previous examinations. Management has not exerted sufficient effort to effect compliance and may lack the ability to effectively administer fiduciary activities. The level of compliance problems is significant and, if left unchecked, may subject the institution to monetary losses or reputation risk. Risks are inadequately identified, measured, monitored and controlled.

5. A rating of 5 indicates critically deficient compliance practices. Account administration is critically deficient or incompetent and there is a flagrant disregard for the terms of the governing instruments and interests of account beneficiaries. The institution frequently engages in transactions that compromise its fundamental duty of undivided loyalty to account beneficiaries. There are flagrant or repeated violations of laws and regulations and significant departures from sound fiduciary principles. Management is unwilling or unable to operate within the scope of laws and regulations or within the terms of governing instruments and efforts to obtain voluntary compliance have been unsuccessful. The severity of noncompliance presents an imminent monetary threat to account beneficiaries and creates significant legal and financial exposure to the institution. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the ability of management to continue engaging in fiduciary activities.

Asset Management. The asset management rating reflects the risks associated with managing the assets (including cash) of others. Prudent

portfolio management is based on an assessment of the needs and objectives of each account or portfolio. An evaluation of asset management should consider the adequacy of processes related to the investment of all discretionary accounts and portfolios, including collective investment funds, proprietary mutual funds, and investment advisory arrangements.

The institution's asset management activities subject it to reputation, compliance and strategic risks. In addition, each individual account or portfolio managed by the institution is subject to financial risks such as market, credit, liquidity, and interest rate risk, as well as transaction and compliance risk. The ability of management to identify, measure, monitor and control these risks is reflected in this rating.

The asset management rating is based upon, but not limited to, an assessment of the following evaluation factors:

- The adequacy of overall policies, practices and procedures governing asset management, considering the size, complexity and risk profile of the institution's fiduciary activities.
- The decision making processes used for selection, retention and preservation of fiduciary assets including adequacy of documentation, committee review and approval, and a system to review and approve exceptions.
- The use of quantitative tools used to measure the various financial risks in investment accounts and portfolios.
- The existence of policies and procedures addressing the use of derivatives or other unusual investment products.
- The adequacy of procedures related to the purchase or retention of miscellaneous assets including real estate, notes, closely held companies, limited partnerships, mineral interests, insurance and other unique assets.
- The extent and adequacy of periodic reviews of investment performance, taking into consideration the needs and objectives of each account or portfolio.
- Monitoring of changes in the composition of fiduciary assets for trends and related risk exposure.
- Quality of investment research used in the decision-making process and documentation of the research.
- Due diligence process for evaluating investment advice received from vendors and/or brokers (including approved or focus lists of securities).
- Due diligence process for reviewing and approving brokers and/or counter parties used.

This rating may not be applicable for some institutions because their

operations do not include activities involving the management of any fiduciary assets. Functions of this type would include, but not necessarily be limited to clearing corporations or depositories, directed agency relationships, security clearance, non-fiduciary custody relationships, transfer agent and registrar activities. In institutions of this type, the rating for Asset Management may be omitted by the examiner in accordance with the examining agency's implementing guidelines.

Ratings.

1. A rating of 1 indicates strong asset management practices. Identified weaknesses are minor in nature. Risk exposure is modest in relation to management's abilities and the size and complexity of the assets managed.

2. A rating of 2 indicates satisfactory asset management practices. Moderate weaknesses are present and are well within management's ability and willingness to correct. Risk exposure is commensurate with management's abilities and the size and complexity of the assets managed. Supervisory response is limited.

3. A rating of 3 indicates that asset management practices are less than satisfactory in relation to the size and complexity of the assets managed. Weaknesses may range from moderate to severe; however, they are not of such importance as to pose a threat to the interests of the account beneficiaries generally. Asset management and risk management practices generally need to be improved. An elevated level of supervision is normally required.

4. A rating of 4 indicates deficient asset management practices in relation to the size and complexity of the assets managed. The levels of risk are significant and inadequately controlled. The problems pose a threat to account beneficiaries generally, and if left unchecked, may subject the institution to losses and could undermine the reputation of the institution.

5. A rating of 5 represents critically deficient asset management practices and a flagrant disregard of fiduciary duties. A continuation of these practices jeopardizes the interests of the beneficiaries generally, and may pose a threat to the soundness of the institution.

[End of Proposed Text of Uniform Interagency Trust Rating System]

Dated: February 10, 1998.

Joe M. Cleaver,

Executive Secretary, Federal Financial Institutions Examination Council.

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