

# RESCINDED

This document and any attachments are superseded by Comptroller's Handbook - Bank Supervision Process.

## Assignment of Ratings

### INTRODUCTION

The Uniform Interagency Trust Rating System (UITRS) is a supervisory examination rating system used by the federal banking agencies for evaluating on a uniform basis the administration of trust and asset management activities of financial institutions and uninsured trust companies. The UITRS is also used by the agencies to identify those institutions requiring special supervisory attention. The UITRS was revised by the Federal Financial Institutions Examination Council in 1998. The OTS, in Transmittal TR-215, December 29, 1998 gave notice of its adoption of the updated rating system for all trust and asset management examinations commencing after January 1, 1999.

Under the UITRS, each institution is assigned a composite rating based on an evaluation and rating of the essential components of an institution's trust and asset management activities. The composite rating reflects the overall condition of an institution's trust and asset management activities and is used by the federal banking agencies to monitor aggregate trends.

The UITRS requires trust and asset management earnings to be evaluated on all institutions. However, OTS will assign a rating for the earnings component only for those institutions that, at the time of the examination, have total trust department assets of more than \$100 million or are a trust-only institution. OTS does not utilize the alternative earning rating.

The asset management rating may not be applicable for some institutions because their operations do not include activities involving the management of discretionary assets or the offering of investment advice. Nonasset management functions would include, but not necessarily be limited to, directed agency relationships, securities clearing, nonfiduciary custody relationships, transfer agent, and registrar activities. In institutions having only nonasset management accounts, the examiner may omit the rating for asset management. However, this component should be assigned when the institution provides investment advice, even though it does not have discretion over the account assets. An example of this type of activity would be where the institution selects or recommends the menu of mutual funds offered to participant directed 401(k) plans.

### OVERVIEW OF TRUST RATING SYSTEM

Assigned composite ratings under the UITRS are based on an evaluation and rating of five essential components of an institution's trust and asset management activities. These components 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 fiduciary principles; and the management of trust assets.

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.

Determination of the composite and component ratings takes into consideration the size and sophistication, the nature and complexity, and the risk profile of the institution’s trust and asset management activities.

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 trust and asset management 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 trust and asset management activities or products, is an important factor in establishing an institution’s overall 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 trust and asset management 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 trust and asset management 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.

## COMPOSITE RATINGS

Composite ratings are based on a careful evaluation of how an institution conducts its trust and asset management 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 trust and asset management activities upon the soundness of the institution. The five key components used to assess

an institution's trust and asset management activities are: the capability of management; the adequacy of operations, controls, audits and information technology; the quality and level of earnings; compliance with governing instruments, applicable law (including self-dealing and conflicts of interest laws and regulations), and sound fiduciary principles; and the management of fiduciary assets. The five composite ratings are defined as follows:

#### Composite 1

Administration of trust and asset management activities is sound in every respect. 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 applicable law. Risk management practices are strong relative to the size, complexity, and risk profile of the institution's trust and asset management activities. Fiduciary activities are conducted in accordance with applicable law and fiduciary principles and give no cause for supervisory concern.

#### Composite 2

Administration of trust and asset management 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. Trust and asset management activities are conducted in substantial compliance with applicable law. 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 oversight is informal and limited.

#### Composite 3

Administration of trust and asset management 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 timeframes. Additionally, trust and asset management activities may reveal some significant noncompliance with applicable law. 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 trust and asset management activities require more than normal supervision and may include formal or informal enforcement actions.

#### Composite 4

Trust and asset management 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 on 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 applicable law. Risk management practices are generally unacceptable

relative to the size, complexity, and risk profile of the trust and asset management activities. These problems pose a threat to trust beneficiaries generally and, if left unchecked, could evolve into conditions that could cause significant losses to the institution and 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

Trust and asset management activities are conducted in an extremely unsafe and unsound manner. Administration of trust and asset management activities is critically deficient in numerous major respects. Problems result from incompetent or negligent administration, flagrant and/or repeated disregard for applicable law, 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 trust and asset management 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 trust and asset management activities. It also reflects their ability to ensure that the institution's trust and asset management activities are conducted in a safe and sound manner and in compliance with applicable law. Directors should provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures, and practices are established and followed. Senior 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 trust and asset management 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 trust and asset management activities; and effective risk monitoring and management information systems. This rating should reflect the board and management's ability as it applies to all aspects of trust and asset management activities in which the institution is involved.

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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 trust and asset management 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 adequacies of, and conformance with, appropriate internal policies, practices, and controls that address the operations and risks of significant trust and asset management activities;
- The accuracy, timeliness, and effectiveness of management information and risk monitoring systems appropriate for the institution's size, complexity, and trust and asset management risk profile;
- The overall level of compliance with applicable laws and fiduciary principles, including sound ethical behavior;
- Responsiveness to recommendations from auditors and regulatory authorities;
- Strategic planning for trust and asset management products and services;
- The level of experience and competence of trust and asset management staff, including issues relating to turnover and succession planning;
- The adequacy of insurance coverage;
- The availability of competent legal counsel;
- The extent and nature of pending litigation associated with trust and asset management activities and its potential impact on earnings, capital, and the institution's reputation; and
- The process for identifying and responding to customer complaints.

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 trust and asset management activities. All significant risks are consistently and effectively identified, measure, monitored, and controlled. Management and the board are proactive, and have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

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

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

A *rating of 4* indicates deficient management and board performance or risk management practices that are inadequate considering the size, complexity, and risk profile of the institution's trust and asset management activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, and 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.

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, and controlled and now pose a threat to the safety of accounts. Replacing or strengthening management or the board of directors is necessary.

## Operations, Internal Controls, Auditing, and Information Technology

This rating reflects the adequacy of the institution's trust and asset management operating systems and internal controls in relation to the volume and character of business conducted. Audit coverage must assure the integrity of the financial records, the sufficiency of internal controls, and the adequacy of the compliance process. Information technology controls ensure the adequacy and integrity of computer systems including network, personal computers, servers, and third party providers.

The institution's trust and asset management operating systems, internal controls, audit, and information technology functions subject it primarily to transaction and compliance risk. Other risks including reputation, strategic, and financial risk may also be present. The ability of management to identify, measure, monitor, and control these risks is reflected in this rating.

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

**Operations and Internal Controls**, including the adequacy of:

- Staff, facilities, and operating systems;
- Records, accounting, and data processing systems (including controls over system access and accounting procedures such 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 (check or electronic) and unissued securities;
- Controls over income processing activities;
- Reconciliation processes (depository, cash, vault, locust, and suspense accounts, etc.);
- Disaster and/or business recovery programs;
- Hold-mail procedures and controls over returned mail;
- Investigation and proper escheatment of funds in dormant accounts

**Auditing**, including:

- The independence, frequency, quality, and scope of the internal and external trust and asset management audit function relative to the volume, character, and risk profile of the institution's trust and asset management activities;
- The volume and/or severity of internal control and audit exceptions and the extent to which these issues are tracked and resolved; and
- The experience and competence of the audit staff.

**Information Technology**, including:

- The adequacy of management oversight and controls for evaluating IT risk and providing for a safe and prudent electronic environment;
- The effectiveness of policies, practices, and strategies to ensure critical controls exist, information security is sound, and systems are sufficient to prudently conduct trust and asset management activities; and

- The existence of written contingency plans to address back up and restoration of data when primary systems fail or are damaged.

A *rating of 1* indicates that operations, internal controls, audits, and information technology are strong in relation to the volume and character of the institution's trust and asset management activities. All significant risks are consistently and effectively identified, measured, monitored, and controlled.

A *rating of 2* indicates that operations, internal controls, audits, and information technology are satisfactory in relation to the volume and character of the institution's trust and asset management activities. Moderate weaknesses may exist, but are not material. Significant risks, in general, are effectively identified, measured, monitored, and controlled.

A *rating of 3* indicates that operations, internal controls, audits, and information technology need improvement in relation to the volume and character of the institution's trust and asset management activities. One or more of these areas are less than satisfactory. Problems and significant risks may be inadequately identified, measured, monitored, and controlled.

A *rating of 4* indicates deficient operations, internal controls, audits, or information technology. One or more of these areas are inadequate or the level of problems and risk exposure is excessive in relation to the volume and character of the institution's trust and asset management activities. Problems and significant risks are inadequately identified, measured, monitored, and controlled and require immediate action. Institutions with this level of deficiencies may make little provision for audits or may evidence weak or potentially dangerous operating practices in combination with infrequent or inadequate audits.

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

## Earnings

This rating reflects the profitability of an institution's trust and asset management activities and its effect on the financial condition of the institution. The use and adequacy of budget and earnings projections by functions, product lines, and clients are reviewed and evaluated. Risk exposure that may lead to negative earnings is also evaluated. An evaluation of earnings is required for all institutions with trust and asset management activities. An assignment of an earnings rating, however, is required only for institutions that, at the time of the examination, have total trust assets of more than \$100 million or are a trust only institution.

For institutions where the assignment of an earnings rating is not required by the UTRS, each federal banking agency has the option to assign an alternative set of ratings. It is OTS policy to assign a rating to only those trust departments with more than \$100 million or trust-only institutions. OTS does not utilize the alternative earnings rating.



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

- The profitability of trust and asset management activities in relation to the size and scope of these activities and to the overall business of the institution;
- The overall importance to the institution of offering trust and asset management services to its customers and local community; and
- The effectiveness of the institution's procedures for monitoring trust and asset management activity income and expenses relative to the size and scope of these activities and their relative importance to the institution, including the frequency and scope of profitability reviews and planning by the institution's board of directors or a committee thereof.

For those institutions for which a rating of earnings is mandatory, additional factors should include the following:

- The level and consistency of profitability, or the lack thereof, generated by the institution's trust and asset management activities in relation to the volume and character of the institution's business;
- Dependence upon nonrecurring fees and commissions, such as fees on court accounts;
- The effects of charge-offs or compromise actions;
- Unusual features regarding the composition of business and fee schedule;
- Accounting practices that contain practices such as (1) unusual methods of allocating direct and indirect expenses and overhead or (2) unusual methods of allocating trust and asset management income and expense where two or more institutions within the same holding company family share services and/or processing functions;
- The 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; and
- 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.

A *rating of 1* indicates strong earnings. The institution consistently earns a rate of return on its trust and asset management activities that is commensurate with the risk of those activities. This rating would normally be supported by a history of consistent profitability over time and a judgment that future earnings prospects are favorable. In addition, management techniques for evaluating and monitoring

earnings performance are fully adequate and there is appropriate oversight by the institution's board of directors or a committee thereof. Management makes effective use of budgets and cost analysis procedures. Methods used for reporting earnings information to the board of directors, or a committee thereof, are comprehensive.

A *rating of 2* indicates satisfactory earnings. Although the earnings record may exhibit some weaknesses, earnings performance does not pose a risk to the overall institution nor to its ability to meet its obligations. Generally, trust and asset management earnings meet management targets and appear to be at least sustainable. Management processes for evaluating and monitoring earnings are generally sufficient in relation to the size and risk of trust and asset management activities that exist and any deficiencies can be addressed in the normal course of business. A rating of 2 may also be assigned to institutions with a history of profitable operations if there are indications that management is engaging in activities with which it is not familiar or where there may be inordinately high levels of risk present that have not been adequately evaluated. Alternatively, an institution with an otherwise strong earnings performance may also be assigned a 2 rating if there are significant deficiencies in its methods used to monitor and evaluate earnings.

A *rating of 3* indicates less than satisfactory earnings. Earnings are not commensurate with the risk associated with trust and asset management activities. Earnings may be erratic or exhibit downward trends and future prospects are unfavorable. This rating may also be assigned if management processes for evaluating and monitoring earnings exhibit serious deficiencies, provided the deficiencies identified do not pose an immediate danger to either the overall financial condition of the institution or its ability to meet its trust and asset management obligations.

A *rating of 4* indicates earnings that are seriously deficient. Trust and asset management activities have a significant adverse effect on the overall income of the institution and its ability to generate adequate capital to support the continued operation of its trust and asset management activities. The institution is characterized by trust and asset management earnings performance that is poor historically or faces the prospect of significant losses in the future. Management processes for monitoring and evaluating earnings may be poor. The board of directors has not adopted appropriate measures to address significant deficiencies.

A *rating of 5* indicates critically deficient earnings. In general, an institution with this rating is experiencing losses from trust and asset management activities that have a significant negative impact on the overall institution, representing a distinct threat to its viability through the erosion of its capital. The board of directors has not implemented effective actions to address the situation.

## Compliance

This rating reflects an institution's overall compliance with applicable law, accepted standards of fiduciary conduct, governing account instruments, duties associated with account administration, and internally established policies and procedures. This component specifically incorporates an assessment of a fiduciary's duty of undivided loyalty and compliance with applicable law and accepted standards of fiduciary conduct related to self-dealing and other conflicts of interest.

The compliance component includes reviewing and evaluating the adequacy and soundness of adopted policies, procedures, and practices generally, and as they relate to specific transactions and accounts. It also includes reviewing policies, procedures, and practices to evaluate the sensitivity of management and the board of directors to refrain from self-dealing, minimize potential conflicts of interest, and resolve actual conflict situations in favor of account beneficiaries.

Risks associated with account administration are potentially unlimited because each account is a separate contractual relationship that contains specific obligations. Risks associated with account administration include failure to comply with applicable law or terms of the governing instrument; inadequate account administration practices; inexperienced management; or inadequately trained staff. Risks associated with a fiduciary duty of undivided loyalty generally stem from engaging in self-dealing or other conflict of interest transactions. An institution may be exposed to compliance, strategic, financial and reputation 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 trust and asset management business.

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

- Compliance with applicable federal and state statutes and regulations, including, but not limited to, federal and state trust and fiduciary laws; the Employee Retirement Income Security Act of 1974; federal and state securities laws; state investment standards; state principal and income acts, state probate codes, and the Internal Revenue Code of 1954;
- Compliance with the terms of governing instruments;
- The adequacy of overall policies, practices and procedures governing compliance, considering the size, complexity and risk profile of the institution's trust and asset management activities;
- The adequacy of policies and procedures addressing account administration;
- The adequacy of policies and procedures addressing conflicts of interest, including those designed to prevent the improper use of "material inside information";
- The effectiveness of systems and controls in place to identify actual and potential conflicts of interest;
- The adequacy of management practices to ensure appropriate ethical behavior and standards exist;
- The adequacy of securities trading policies and practices relating to the allocation of brokerage business, the payment of services with "soft dollars" and the combining, crossing and timing of trades;

- The extent and permissibility of transactions with related parties, including, but not limited to, the volume of related commercial and fiduciary relationships and holdings of corporations in which directors, officers, or employees of the institution may be interested;
- The adequacy of disclosures to address relationships with affiliates, allocation of fees, and transparency of fee agreements with third parties.
- The decision-making process used to accept, review, and terminate accounts; and
- The decision-making process related to account administration duties, including cash balances, overdrafts, and discretionary distributions.

A *rating of 1* indicates strong compliance policies, procedures, and practices. Policies and procedures covering conflicts of interest and account administration are appropriate in relation to the size and complexity of the institution's trust and asset management activities. Accounts are administered in accordance with governing instruments, applicable law, 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.

A *rating of 2* indicates fundamentally sound compliance policies, procedures, and practices in relation to the size and complexity of the institution's trust and asset management activities. Account administration may contain moderate weaknesses in policies, procedures, or practices. Management's practices indicate a determination to minimize the instances of conflicts of interest. Trust and asset management activities are conducted in substantial compliance with applicable law and fiduciary principles and any violations are generally technical in nature. Management corrects violations in a timely manner and without loss to trust and asset management accounts. Significant risks are effectively identified, measured, monitored, and controlled.

A *rating of 3* indicates compliance practices that are less than satisfactory in relation to the size and complexity of the institution's trust and asset management activities. Policies, procedures, and controls have not proven effective and require strengthening. Material weaknesses exist in account administrative practices. Trust and asset management activities may be in substantial noncompliance with applicable law, governing instruments, or fiduciary principles but losses are no worse than minimal. While management may have the ability to achieve compliance, the number of violations that exist or the 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.

A *rating of 4* indicates an institution with deficient compliance practices in relation to the size and complexity of its trust and asset management activities. 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 applicable law 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 trust and asset management 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.

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 applicable law and significant departures from 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 trust and asset management activities.

### Asset Management

This 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 common and 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 discretionary accounts;
- The decision-making processes used for selection, retention, and preservation of discretionary assets including adequacy of documentation, committee review, and approval, and a system to review and approve exceptions;
- The use of quantitative tools to measure the various financial risks in investment accounts and portfolios;
- The existence of policies and procedures addressing the use of derivatives or other complex 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;
- The monitoring of changes in the composition of discretionary fiduciary assets for trends and related risk exposures;
- The quality of investment research used in the decision-making process and documentation of the research;
- The due diligence process for evaluating investment advice received from vendors and/or brokers (including approved or focus lists of securities); and
- The due diligence process for reviewing and approving brokers and/or counter parties used by the institution.

This rating may not be applicable for some institutions because their operations do not include activities involving the management of any discretionary assets or the provision of investment advice. Examples would include, but not necessarily be limited to, direct agency relationships, securities clearing, nonfiduciary custody relationships, transfer agent and registrar activities. In institutions with nondiscretionary or investment advisory accounts, the rating for asset management may be omitted by the examiner in accordance with the examining agency's implementing guidelines. However, this component should be assigned when the institution provides investment advice, even though it does not have discretion over the account assets. An example of this type of activity would be where the institution selects or recommends the menu of mutual funds offered to participant directed 401(k) plans.

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.

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.

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 significance as to generally pose a threat to the interests of account beneficiaries. Asset management and risk management practices generally need to be improved. An elevated level of supervision is normally required.

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.

A *rating of 5* represents critically deficient asset management practices and a flagrant disregard of fiduciary duties. These practices jeopardize the interests of account beneficiaries, subject the institution to losses, and may pose a threat to the soundness of the institution.

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