ARKANSAS STATE BANK DEPARTMENT
EXAMINATION POLICY

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SUBJECT: **Disclosure of Trust Component Ratings**

BACKGROUND

The Uniform Interagency Trust Rating System (UITRS) was developed by the Federal Financial Institutions Examination Council (FFIEC) and has been utilized by the Arkansas State Bank Department for several years. On April 1, 1996, the Arkansas State Bank Department made a decision to advise Boards of Directors of state-chartered banks of the entire UITRS rating assigned pursuant to an examination by this agency. By disclosing all component ratings, it is felt that bank directors are more fully informed of the condition of the bank's trust department, as indicated by the assigned component ratings, and therefore better equipped to address all fiduciary and operational deficiencies.

Effective January 1, 1999, the updated rating system will be utilized by the Arkansas State Bank Department. This rating system is also used by federal bank regulatory agencies. Each bank's Board of Directors are advised of the assigned rating in the examination report, and the rating will not be a matter of public information. The rating disclosed in the examination report is that assigned by the Examiner in Charge and approved by supervisory personnel and the Bank Commissioner as a result of an independent examination by the Arkansas State Bank Department or as a result of a joint or concurrent examination in which the Arkansas State Bank Department participated. While the UITRS rating assigned by the Arkansas State Bank Department may be the same as that assigned by the respective federal agency, some differences in component and composite ratings may exist. It is important to note that the overall uniform bank rating is not an arithmetic mean of the five component ratings, but the composite rating should be consistent with the individual performance ratings.

OVERVIEW OF THE RATING SYSTEM

Under the UITRS, the fiduciary activities of financial institutions are assigned a composite rating based on an evaluation and rating of five critical components of an institution's fiduciary activities. The specific dimensions that are to be evaluated are the following:

Management
Operations, Internal Controls & Auditing
Earnings
Compliance
Asset Management

Each of these dimensions is to be rated on a scale of 1 through 5 in descending order of performance quality. Thus, 1 represents the highest rating indicating the strongest performance and risk management practices and 5 indicating weak performance and risk management practices (and most critically deficient) and the lowest level of operating performance.

Each trust department is accorded a composite rating that is predicated upon the evaluations of the specific performance dimensions. The composite or overall rating is assigned predicated upon the ratings assigned to the critical areas. This rating signifies the general condition of the department, and should be consistent with the criteria and evaluating factors defined in the UITRS. The composite rating is also based upon a scale of “1” through “5” in ascending order of supervisory concern. In arriving at a composite rating, each financial dimension must be weighed, and due consideration given to the interrelationships among the various aspects of a bank’s trust department operations. The delineation of specific performance dimensions does not preclude consideration of other factors that, in the judgment of the examiner or reviewer, are deemed relevant to accurately reflect the overall condition and soundness of a particular bank’s trust department. However, the assessment of the specific performance dimensions represents the essential foundation upon which the composite rating is based.

COMPOSITE RATING

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 composite ratings of the overall condition of a trust department are defined and distinguished as follows:

Composite 1

Administration of fiduciary 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 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 reveal some 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 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

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.

PERFORMANCE EVALUATION

As already noted, the five key performance dimensions – Management, Operations, Internal Controls and Auditing, Earnings, Compliance and Asset Management -- are to be evaluated on a scale of one to five. The following is a description of the gradations to be utilized in the assignment of performance ratings:

Rating No. 1 - indicates strong performance. It is the highest rating and is indicative of performance that is significantly higher than average.

Rating No. 2 - reflects satisfactory performance. It reflects performance that is average or above; it includes performance that adequately provides for the operation of the trust department without loss to the fiduciary account holders.

Rating No. 3 - represents performance that is marginally adequate and is flawed to some degree; as such is considered fair. It is neither satisfactory nor marginal but is characterized by performance that allows for faithful discharge of fiduciary obligations.

Rating No. 4 - represents marginal performance which is significantly below average. If left unchecked, such performance might evolve into weaknesses or conditions that could threaten the account beneficiaries and the viability of the institution.

Rating No. 5 - is considered unsatisfactory (poor). It is the lowest rating and is indicative of performance that is critically deficient in numerous major respects and in need of immediate remedial attention. Such performance by itself, or in combination with other weaknesses, could threaten the interest of the trust beneficiaries and the viability of the institution.

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.

The management rating (1 through 5) 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:

(a) 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;
(b) 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;
(c) The adequacy of, and conformance with, appropriate internal policies, practices and controls addressing the operations and risks of significant fiduciary activities;
(d) The accuracy, timeliness, and effectiveness of Management information and risk monitoring systems appropriate for the institution's size, complexity, and fiduciary risk profile;
(e) The overall level of compliance with laws, regulations, and sound fiduciary principles;
(f) Responsiveness to recommendations from auditors and regulatory authorities;
(g) Strategic planning for fiduciary products and services;
(h) The level of experience and competence of fiduciary management and staff, including issues relating to turnover and succession planning;
(i) The adequacy of insurance coverage;
(j) The availability of competent legal counsel, and the extent and nature of pending litigation associated with fiduciary activities, and its potential impact on earnings, capital, and the institution's reputation; and
(k) The process for identifying and responding to fiduciary customer complaints.

<u>Ratings</u>

A 1 rating 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 are proactive and have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

A 2 rating indicates satisfactory Management and Board performance and risk management practices relative to the size, complexity and risk profile of the institution's fiduciary activities. Moderate weaknesses may exist but are not material to the sound administrations of fiduciary 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 fiduciary activities. The capabilities of Management or the Board of Directors may be insufficient for the size, complexity, and risk profile of the institution's fiduciary activities. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

The 4 rating indicates deficient management and board performance or risk management practices that are inadequate considering the size, complexity, and risk profile of the 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.

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, and pose 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 rating reflects the adequacy of the institution's fiduciary 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.

The institution's fiduciary operating systems, internal controls, and audit function subject it primarily to transaction and compliance risk. The operations, internal controls and auditing rating

(1 through 5) is based upon, but not limited to, an assessment of the following evaluation factors:

Operations and Internal Controls, including the adequacy of:

(a) Staff, facilities and operating systems;
(b) 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);
(c) Trading functions and securities lending activities;
(d) Vault controls and securities movement;
(e) Segregation of duties;
(f) Controls over disbursements (checks or electronic) and unissued securities;
(g) Controls over income processing activities;
(h) Reconciliation processes (depository, cash, vault, sub-custodians, suspense accounts, etc.);
(i) Disaster and/or business recovery programs;
(j) Hold-mail procedures and controls over returned mail; and,
(k) Investigation and proper escheatment of funds in dormant accounts.

Auditing including the adequacy of:

(a) 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;
(b) The volume and/or severity of internal control and audit exceptions and the extent to which these issues are tracked and resolved; and
(c) The experience and competence of the audit staff.

Ratings

A rating of 1 indicates that operations, internal controls, and auditing are strong in relation to the volume and character of the institution's fiduciary activities. All significant risks are consistently and effectively identified, measured, monitored, and controlled.

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

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

A rating of 4 indicates deficient operations, internal controls or audits. 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 fiduciary activities. Problems and significant risks are inadequately identified, measured or monitored, or controlled and require immediate action. Institutions with this level of deficiencies may make little provisions for audits, or may evidence weak or potentially dangerous operating practices in combination with infrequent or inadequate audits.

The 5 rating indicates critically deficient operations, internal controls 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 rating reflects the profitability of an institution's fiduciary activities 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.

An evaluation of earnings is required for all institutions with fiduciary 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 non- deposit trust company. For institutions where the assignment of an Earnings rating is not required by the UITRS, the supervisory agency has the option to assign an earnings rating using an alternate set of ratings.

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

(a) The profitability of fiduciary activities in relation to the size and scope of those activities and to the overall business of the institution.
(b) The overall importance to the institution of offering fiduciary services to its customers and local community.

(c) The effectiveness of the institution's procedures for monitoring fiduciary activity income and expense 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 (1 through 5) of earnings is mandatory, additional factors should include the following:

(a) The level and consistency of profitability, or the lack thereof, generated by the institution's fiduciary activities in relation to the volume and character of the institution's business.
(b) Dependence upon non-recurring fees and commissions, such as fees for court accounts.
(c) The effects of charge-offs or compromise actions.
(d) Unusual features regarding the composition of business and fee schedules.
(e) Accounting practices that contain practices such as (1) unusual methods of allocating direct and indirect expenses and overhead, or (2) unusual 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.
(f) The extent of Management's use of budgets, projections and other cost analysis procedures.
(g) Methods used for Directors' approval of financial budgets and/or projections.
(h) Management's attitude toward growth and new business development.
(i) 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.

<u>Ratings</u>

A rating of 1 indicates strong earnings. The institution consistently earns a rate of return on its fiduciary activities that is commensurate with the risk of those activities. This rating would normally be supported by a history of consistent profitability over the time and a judgement that future earnings prospects are favorable. In addition, Management technique 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 fiduciary obligations. Generally, fiduciary earnings meet Management targets and appear to be at least sustainable. Management processes for evaluating and monitoring earnings are generally sufficient in relationship to the size and risk of fiduciary 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 inordinately high levels of risk present that have not been adequately evaluated. Alternatively, an institution with 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 the fiduciary activities undertaken. 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 fiduciary obligations.

A rating of 4 indicates earnings that are seriously deficient. Fiduciary 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 fiduciary activities. The institution is characterized by fiduciary 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 fiduciary 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.

<u>Alternate Rating of Earnings</u>

Alternate ratings (1 through 5) are assigned based on the level of implementation of four minimum standards by the board of directors and management. These standards are:

(a) Standard No. 1--The institution has reasonable methods for measuring income and expense commensurate with the volume and nature of the fiduciary services offered.
(b) Standard No. 2--The level of profitability is reported to the Board of Directors, or a committee thereof, at least annually.
(c) Standard No. 3--The Board of Directors periodically determines that the continued offering of fiduciary services provides an essential service to the institution's customers or to the local community.
(d) Standard No. 4--The Board of Directors, or a committee thereof, reviews the justification for the institution to continue to offer fiduciary services even if the institution does not earn sufficient income to cover the expenses of providing those services.

<u>Ratings</u>

A rating of 1 may be assigned where an institution has implemented all four minimum standards. If fiduciary earnings are lacking, management views this as a cost of doing business as a full-service institution and believes that the negative effects of not offering fiduciary services are more significant than the expense of administrating those services.

A rating of 2 may be assigned where an institution has implemented, at a minimum, at least three of the four standards. This rating may be assigned if the institution is not generating positive earnings or where formal earnings information may not be available.

A rating of 3 may be assigned if the institution has implemented at least two of the four standards. While Management may have attempted to identify and quantify other revenue to be earned by offering fiduciary services, it has decided that these services should be offered as a service to customers, even if they cannot be operated profitably.

A rating of 4 may be assigned if the institution has implemented only one of the four standards. Management has undertaken little or no effort to identify or quantify the collateral advantages, if any, to the institution from offering fiduciary services.

A rating of 5 may be assigned if the institution has implemented none of the standards.

Compliance

This rating reflects an institution's overall compliance with applicable laws, regulations, 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 laws, regulations, and accepted standards of fiduciary conduct related to self-dealing and other conflicts of interest.

The compliance rating (1 through 5) is based upon, but not limited to, an assessment of the following evaluation factors:

(a) Compliance with 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;
(b) Compliance with the terms of governing instruments;
(c) The adequacy of overall policies, practices, and procedures governing compliance, considering the size, complexity, and risk profile of the institution's fiduciary activities;
(d) The adequacy of policies and procedures addressing account administration;
(e) The adequacy of policies and procedures addressing conflicts of interest, including those designed to prevent the improper use of "material inside information";
(f) The effectiveness of systems and controls in place to identify actual and potential conflicts of interest;
(g) 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;
(h) 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;
(i) The decision making process used to accept, review, and terminate accounts; and,
(j) The decision making process related to account administration duties, including cash balances, overdrafts, and discretionary distributions.

Ratings

A 1 rating 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 fiduciary activities. 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.

A 2 rating indicates fundamentally sound compliance policies, procedures and practices in relation to the size and complexity of the institution's fiduciary activities. Account administration may be flawed by moderate 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.

A rating of 3 indicates compliance practices that are less than satisfactory in relation to the size and complexity of the institution's fiduciary activities. Policies, procedures and controls have not proven effective and require strengthening. Fiduciary activities may be in substantial noncompliance with laws, regulations or governing instruments, 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 an attention to its compliance responsibilities. Risk management practices generally need improvement.

A 4 rating indicates an institution with deficient compliance practices in relation to the size and complexity of its fiduciary 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 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.

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

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 collective investment funds, proprietary mutual funds, and investment advisory arrangements.

The asset management rating (1 through 5) is based upon, but not limited to, an assessment of the following evaluation factors:

(a) The adequacy of overall policies, practices and procedures governing asset management, considering the size, complexity and risk profile of the institution's fiduciary activities.
(b) 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.
(c) The use of quantitative tools to measure the various financial risks in investment accounts and portfolios.
(d) The existence of policies and procedures addressing the use of derivatives or other complex investment products.
(e) 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.
(f) The extent and adequacy of periodic reviews of investment performance, taking into consideration the needs and objectives of each account or portfolio.
(g) The monitoring of changes in the composition of fiduciary assets for trends and related risk exposure.
(h) The quality of investment research used in the decision-making process and documentation of the research.
(i) The due diligence process for evaluating investment advice received from vendors and/or brokers (including approved or focus lists of securities).
(j) 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. Functions of this type would include, but not necessarily be limited to, directed agency relationships, securities clearing, 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. 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.

<u>Ratings</u>

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.