FEDERAL RESERVE BANK
OF NEW YORK

At Circ. No. 8427 (a)

September 28, 1978

UNIFORM INTERAGENCY TRUST RATING SYSTEM

To the Chief Executive Officer of Each State Member Bank in the Second Federal Reserve District:

Following is the text of a statement announcing the adoption by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, of a uniform interagency system for rating the trust departments of commercial banks:

The three Federal bank regulatory agencies announced today [September 21] the adoption of a uniform interagency system for rating the trust departments of the nation's commercial banks.

In adopting the new system, the three agencies said:

"The Uniform Interagency Trust Rating System recognizes the the consumer oriented nature of trust department activities and emphasizes the trust department's proper role in carrying out its fiduciary responsibilities in the public interest. Examiners are encouraged by the new system to focus on any conditions that could adversely impact the interests of account beneficiaries and to recommend corrective action before any such conditions might give rise to loss either to account beneficiaries or to the bank."

The new trust rating system is currently being implemented by the Office of the Comptroller of the Currency (for national banks), by the Federal Deposit Insurance Corporation (for insured State chartered banks that are not members of the Federal Reserve System), and by the Federal Reserve Board (for State chartered member banks).

The uniform system for rating trust departments of commercial banks has two main elements:

1. An assessment by Federal bank examiners of six critical areas of a trust department's administration and operations. These areas encompass the capability of the department's management, the soundness of the policies and procedures to carry out the department's fiduciary obligations, the quality of service rendered to the public, and the effect of the department's activities on the soundness of the bank.

(Over)

The six critical areas are:

--Supervision and organization of the trust department

--The department's operations, controls and audits

--Asset administration

--Account administration

--Conflicts of interest

--Earnings, volume trends and prospects.

Examiners will rate each of these critical areas of the trust department on a scale of 1 to 5, with "1" representing the top and "5" the bottom of the scale.

2. A combination of these ratings into a composite --overall-- rating of the trust department. This composite rating is arrived at by totaling the ratings assigned to the separate areas.

The agencies agreed upon qualitative guidelines examiners will use in rating the six critical areas and in combining these ratings into a composite rating.

Agreement on the factors that constitute the main characteristics of a trust department's operations and soundness, and on how those factors should be combined into an overall rating, is expected to provide a basis for comparable judgments about bank trust departments by all three Federal agencies and enhance interagency evaluations and reports by the agencies to Congress and the public. Such a common yardstick is new.

The three agencies in May began to use a similar Uniform Interagency Bank Rating System.

Enclosed is a copy of a description of the "Uniform Interagency Trust Rating System," as adopted by the three Federal bank regulatory agencies. Any questions regarding the rating system may be directed to our Bank Examinations Department (Tel. No. 212-791-5894).

PAUL A. VOLCKER,
President.

UNIFORM INTERAGENCY TRUST RATING SYSTEM

September 12, 1978

UNIFORM INTERAGENCY TRUST RATING SYSTEM

Overview

The Trust Rating System is based upon an evaluation of six critical areas of a trust department's administration and operations that encompass in comprehensive fashion the capability of the department's management, the soundness of adopted policies and procedures, the quality of service rendered to the public and the effect of trust activities upon the soundness of the bank. These areas are:

Supervision and Organization
Operations, Controls and Audits
Asset Administration
Account Administration
Conflicts of Interest
Earnings, Volume Trends and Prospects

Each of these areas is to be rated on a scale of one through five in descending order of performance quality. Thus, "1" represents the highest and "5" the lowest (and most critically deficient) level of performance.

Each trust department is then accorded a summary or composite rating to signify its general condition. The composite rating is predicated upon the rating assigned to each area and is determined by the sum of the individual numerical ratings as follows:

Numerical Score	Composite Rating
6- 8	1
9-14	2
15-20	3
21-26	4
27-30	5

Composite Ratings

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

Composite 1

Trust departments in this group are superior in

Composite 1 (continued)

almost every respect; any critical findings are basically of a minor nature and are not representative of any fundamental deficiency in policies, practices or procedures. Such departments are in the hands of an experienced and competent staff which has the demonstrated ability to administer existing accounts and anticipated future business in strict conformity with applicable laws and regulations and in accordance with sound fiduciary principles.

Composite 2

Trust departments so rated are fundamentally sound but do not measure up in one or more respects to the standards for the top rating. Policies, practices and procedures are generally effective but may reflect modest weaknesses that are readily correctable in the normal course of business. Criticizable features may include isolated instances of noncompliance with laws, regulations or management prescribed policies and procedures but corrective action without loss to the fiduciary accounts is assured.

Composite 3

Trust departments in this group conduct their affairs in a generally adequate manner. Policies and procedures governing important phases of administration or operations may be nonexistent or inadequately defined but practices are generally appropriate to faithful discharge of the department's fiduciary obligations. Some problems of relative significance may exist but none are of such importance as to pose a threat to the trust beneficiaries generally or to the soundness of the bank. Management will generally be regarded as adequate in relation to the volume and character of business administered. The supervisory response is ordinarily limited to follow-up on correction of criticizable features.

Composite 4

Trust departments so rated have one or more major problems centered in inexperienced or inattentive management, failure to adhere to sound administrative practices, Composite 4 (continued)

numerous violations of law or regulation, weak or dangerous operating practices, or an accumulation of unsatisfactory features of lesser importance. Such problems pose a threat to the account beneficiaries generally and, if left unchecked, could evolve into conditions that could ultimately undermine public confidence in the bank. Such departments ordinarily require special supervisory attention.

Composite 5

Trust departments in this group evidence performance or conditions that are critically deficient in numerous major respects arising from incompetent or neglectful administration, flagrant and/or repeated disregard of applicable laws and regulations, or willful departure from sound fiduciary principles and practices. Such conditions evidence a flagrant disregard for the interests of the trust beneficiaries and may pose a serious threat to the soundness of the bank. Such departments require immediate corrective action, constant supervisory attention, and the possible imposition of regulatory sanctions.

Supervision and Organization

A. Scope - this area encompasses the trust department's organization and management including the effectiveness of director supervision and the performance and capabilities of principal officers and supporting staff.

B. Coverage - factors specifically considered include: (a) functional divisions of activities and personnel and the effectiveness thereof; (b) technical competence, leadership and administrative ability of senior trust management; (c) adequacy of supporting staff including provision for any potential succession or turnover problems; (d) extent and effectiveness of director supervision, directly or through committees, care accorded the selection of committee members, and adequacy of committee minutes; (e) availability of and reliance upon competent legal counsel, and (f) sufficiency of liability insurance coverage.

C. Rating Guidelines

Rating No. 1 - department is well-organized and managed, under effective director supervision, and supported by an experienced and competent staff which has the demonstrated ability to cope successfully with existing and foreseeable problems.

Rating No. 2 - department generally possesses the characteristics required for a top rating but may have modest weaknesses in the overall level of supervision or may be fundamentally deficient in regard to the management of one or more functional activities of lesser overall significance.

Rating No. 3 - indicative of an organization and management that may be deficient in several respects but is generally regarded as adequate in relation to the volume and character of business administered; management does little in the way of effective planning and may have difficulty in responding to changing circumstances.

Rating No. 4 - characterizes an organization that is fundamentally deficient in regard to one or more activities of significant overall importance; management is regarded as inexperienced or inattentive and may lack the ability to reasonably respond to changing circumstances or to correct less than satisfactory conditions.

Rating No. 5 - indicative of organizational weaknesses and managerial incompetence of such severity as to warrant immediate action if sound conditions are to be achieved.

Operations, Controls and Audits

A. Scope - this area encompasses the department's operational systems and controls in relation to the volume and character of business conducted, and the adequacy of audit coverage designed to assure the integrity of the financial records and the sufficiency of internal controls.

B. Coverage - factors specifically considered include: (a) the adequacy of facilities, systems and records; (b) effectiveness of controls and safeguards including segregation of duties, vault controls and security movement controls; (c) scope, frequency and quality of audits (internal or external) and reports; (d) where applicable, the qualifications and capability of internal auditors, and (e) the independence and access of auditors to the board of directors.

C. Rating Guidelines

Rating No. 1 - operations are efficient, effectively controlled and subject to comprehensive internal or external audits as the circumstances of the department may require.

Rating No. 2 - characteristics are generally similar to those necessary for a top rating but modest weaknesses exist that are readily correctable in the normal course of business.

Rating No. 3 - characterizes a department that may be fundamentally deficient in respect to one or more activities of lesser importance but, on an overall basis, operating practices and audits are considered adequate in relation to the volume and character of business conducted.

Rating No. 4 - characterizes a department that makes little provision for audits of any kind or that evidences weak or potentially dangerous operating practices in combination with infrequent or inadequate audits.

Rating No. 5 - the department evidences operating practices, with or without audits, that pose a serious threat to the safeguarding of funds and securities.

Asset Administration

A. Scope - this area encompasses policies, practices and procedures relating to the selection, retention and preservation of assets including methods utilized to review, protect and make productive the various types of assets comprising the trust department's aggregate portfolio.

B. Coverage - factors specifically considered include: (a) adequacy of the investment selection and retention process including provision for committee approval and extent of compliance therewith; (b) availability of an approved list of investments and system of approval for deviations therefrom; (c) sources and quality of advice and research and adequacy of documentation to support investment and retention decision-making; (d) as applicable, quality of administration accorded collective investment funds, master notes, real estate, mortgage loans, close corporations, and other asset holdings requiring special expertise, and (e) general quality of asset holdings and sufficiency of supporting documentation.

C. Rating Guidelines

Rating No. 1 - denotes superior performance in all respects; policies and procedures are well-conceived and appropriate to the effective administration of asset holdings; responsibility asset holdings are deemed to be of demonstrable fiduciary quality and/or are supported by sufficient research documentation to evidence the exercise of prudent judgement.

Rating No. 2 - denotes generally superior or above-average performance which is flawed only by modest weaknesses in policies and procedures, in asset quality, and/or in the adequacy of supporting documentation.

Rating No. 3 - asset administration may be flawed by a moderate degree of weakness in supporting documentation or by inadequate or even nonexistent policies and procedures but generally conservative investment practices are followed which pose little or no threat to the trust beneficiaries.

Rating No. 4 - characterizes asset administration that is notably deficient in relation to the volume and character of responsibility asset holdings; such condition may evidence itself in the selection and/or retention of numerous securities or other assets of doubtful fiduciary quality.

Rating No. 5 - characterizes administrative practices that evidence a flagrant disregard of the department's fiduciary obligation to preserve and make productive the trust assets; continuation of such practices could jeopardize the interests of the account beneficiaries generally and could result in surcharge to the bank.

Account Administration

A. Scope - this area encompasses the trust department's policies, practices and procedures relating to the administration of its accounts.

B. Coverage - factors specifically considered include: (a) soundness of adopted policies and procedures and extent of compliance therewith; (b) use of synopsis sheets, familiarity of personnel with account circumstances, and timeliness of administrative actions; (c) administrative consideration accorded acceptance and termination of accounts, cash balances and overdrafts, and discretionary distributions of income and principal including provision for committee approval; (d) process of selection and periodic review of account assets for suitability (in terms of diversification and other investment characteristics), and for conformity with instrument provisions and account objectives including provision for committee approval; (e) familiarity and compliance with applicable laws and regulations, and (f) as applicable, policies and procedures relating to the acceptance and review of direction trusts and other accounts of a unique or unusual nature.

C. Rating Guidelines

Rating No. 1 - denotes superior performance in all respects; policies and procedures are well-conceived and appropriately implemented; individual accounts are suitably administered in conformance with the specific investment and retention powers of the governing instrument or the statutory or case law of the jurisdiction, and in accordance with sound fiduciary principles.

Rating No. 2 - denotes generally superior or above-average performance which is flawed only by modest weaknesses in policies, procedures or practices; corrective action without loss to the fiduciary accounts is assured.

Rating No. 3 - performance may be flawed by a lack of adequate policies and procedures but administrative practices are generally acceptable in relation to the volume and character of accounts under administration.

Rating No. 4 - characterizes account administration that is notably deficient as evidenced by a failure to adhere to sound administrative practices and/or the frequent occurrence of violations of laws, regulations, or terms of the governing instruments.

Rating No. 5 - characterizes neglectful or incompetent administration evidenced by flagrant or repeated disregard of laws, regulations or terms of the governing instruments, and/or significant departures from sound administrative practices.

Conflicts of Interest

A. Scope - this area encompasses the significance of potential conflicts and self-dealing and the adequacy of policies and procedures designed to minimize the potential for resulting abuses. The adequacy of policies and procedures is evaluated in the light of the size of the trust department and the character of its business, the extent of potential and actual conflicts in relation to other departments of similar character and size, and the sensitivity demonstrated by management in attempting to refrain from self-dealing and to minimize potential conflicts and in resolving actual conflicts in favor of the fiduciary accounts.

B. Coverage - factors specifically considered include: (a) adequacy of policies and procedures designed to minimize principal and income cash on deposit in own bank; (b) holdings of stock of own bank or own holding company and its affiliates and the adequacy of policies and procedures relating to the acquisition, retention and voting thereof; (c) volume of related commercial and trust relationships and of holdings of corporations in which directors, officers or employees of the bank may be interested and the adequacy of policies and procedures designed to encourage investment decision-making without improper regard to the interests of commercial banking customers or bank directors, officers and employees; (d) adequacy of policies and procedures designed to prevent the improper use of "material inside information"; (e) adequacy of securities trading policies and practices relating to such matters as the allocation of brokerage business, the payment for services with "soft dollars" and the combining, crossing and timing of trades, and (f) instances of, and aspects of policies and procedures relating to, any such matters as self-dealing and inter-trust dealing.

C. Rating Guidelines

Rating No. 1 - characterizes a department that has adopted and effectively implemented a comprehensive conflict of interest policy statement dealing in adequate fashion with the full range of potential conflicts and self-dealing generally found in departments of similar character and size; such a department is reasonably successful in minimizing the incidents of potential conflicts and always resolves actual conflicts in favor of the fiduciary accounts.

Rating No. 2 - characterizes a department that has moderate weaknesses in policies and procedures but the record affirms management's determination to minimize the instances of abuse.

Rating No. 3 - characterizes a department that evidences few positive efforts to minimize potential conflicts but refrains from self-dealing and is not regularly confronted with either potential or actual conflicts of any significance.

Rating No. 4 - characterizes a department that makes little or no attempt to minimize potential conflicts or to refrain from self-dealing and is confronted with a notable degree of potential or actual conflicts.

Rating No. 5 - characterizes a department that demonstrates a flagrant disregard for the interests of the trust beneficiaries and/or frequently engages in transactions that compromises its fundamental duty of undivided loyalty to the trust beneficiaries.

Earnings, Volume Trends and Prospects

A. Scope - this area encompasses an evaluation of the department's operating results and earnings trends and the probable effect thereon of the volume and character of present and anticipated future business.

B. Coverage - factors specifically considered include: (a) management's attitude towards growth and new business development; (b) dependency upon nonrecurring fees and commission; (c) unusual features regarding the composition of business, fee schedules and effects of charge-offs or compromise actions, and (d) new business development efforts including such factors as types of business solicited, market potential, advertising, competition, and relationships with local organizations.

C. Rating Guidelines

Rating No. 1 - operations in each of the past five years have been profitable without credit for deposit balances; business volume and prospects favor a continuation of this trend.

Rating No. 2 - operating results for the past five years reflect, on average, a net profit without credit for deposit balances; although an occasional loss year is possible, business volume and prospects favor a continuation of five year average profitability.

Rating No. 3 - operations are generally unprofitable but operating losses, when averaged over the previous five-year period, do not exceed the average credit for deposit balances; gross revenues are generally sufficient to permit recovery of salary expenses and a continuation of this trend is likely.

Rating No. 4 - operating losses, when averaged over the previous five-year period, do not exceed the average credit for deposit balances but gross revenues are generally not sufficient to permit recovery of salary expenses; business volume and prospects suggest a continuation of this trend.

Rating No. 5 - operating losses consistently exceed the credit for deposit balances; no reversal of this trend appears likely.

In applying the rating guidelines, the Examiner will place emphasis not only upon existing levels of profitability or unprofitability but also upon the department's new business development efforts and competitive and other market factors in order to determine whether current earnings trends are likely to continue. For example, a department that has been clearly profitable in each of the past five years on the basis of operations may have allowed its performance or its new business efforts to deteriorate to the point where serious doubts now exist as to whether profitability can be sustained. In this case, a rating one step lower than that called for by application of the guidelines may be appropriate. Conversely, a department which has narrowed its losses over the past five years may warrant a rating one step above that called for by application of the guidelines where volume trends and prospects suggest continuing improvement in the earnings trend.

In the case of smaller departments where expenses are not allocated it will be necessary for the Examiner to estimate both total expenses and the credit for deposit balances. For this purpose, salary expenses are determined by adjusting the salaries of individuals engaged in trust activities by the percentage of time devoted to trust activities. The adjusted salary expenses figure is then multiplied by 150% in arriving at a total expense figure. For departments, on the other hand, which allocate direct expenses but not indirect expenses (e.g. overhead expenses; executive supervision), the total of indirect expenses should be stated at 30% of direct expenses in arriving at a total expenses figure. The credit for deposit balances, where not allocated, may be determined by multiplying the average demand balance of trust department funds (using quarter-annual balances) by the average federal funds rate for the year.

It is recognized that the percentages to be applied in arriving at a total expense figure are somewhat arbitrary but their use is encouraged as a means of developing uniformity in this important area. The Examiner may, in his discretion, apply a greater or lesser percentage if warranted by the circumstances of a particular department.

Small part-time departments which operate at a loss and are in business primarily for the purpose of providing full banking services to customers may, in the Examiner's discretion, be rated "4" without regard to the credit for deposit balances.