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Handbook: **Examination Handbook**
Subject: **Administration** **Section: 070**

Ratings: Developing, Assigning, and Presenting

Summary: This bulletin provides new Examination Handbook Section 070, Ratings: Developing, Assigning, and Presenting. This section combines several sections of the Thrift Activities and Compliance Activities Handbooks: Thrift Activities Handbook (TAH) Sections 070, Overall Conclusions; 071, CAMELS Ratings; and 320, Meetings with the Board of Directors; and Compliance Activities Handbook (CAH) Sections 120, Reaching Conclusions and Closing the Examination; and 135, Meetings with the Board of Directors.

For Further Information Contact: Your Office of Thrift Supervision (OTS) Regional Office or the Thrift Policy Division of the OTS, Washington, DC. You may access this bulletin and the handbook section at our web site: www.ots.treas.gov.

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SUMMARY OF CHANGES

OTS is issuing Handbook Section 070, Ratings: Developing, Assigning, and Presenting. This is a new section that combines various sections (see the Summary box above) of the Thrift Activities and Compliance Activities Handbooks so we did not include change bars. We provide a summary of substantive changes below.

070 Ratings: Developing, Assigning, and Presenting

We made changes throughout the handbook section to accommodate a comprehensive safety and soundness and compliance examination process. ***Significant changes require:***

Comments and Conclusions

- Review of CAMELS comments, compliance management comments, and other findings for interrelationships.
- A comprehensive analysis and summary of the savings association's condition based on CAMELS and the Compliance assessments and ratings.
- A comment that assesses and records substantive regulatory violations or compliance program deficiencies.

Assigning Ratings

- An overall assessment of management that includes an assessment of the effectiveness of the compliance management program and management's self-assessment efforts in assigning the Management component rating.

- The management component cannot receive a rating any higher than 2 when compliance is rated 3, which identifies a "less than satisfactory compliance position."

Meetings with Management and the Board of Directors

- You must meet with the board of directors if the association has:
  - — A CAMELS composite or Compliance rating of 4 or 5.
  - — A CAMELS composite or Compliance rating of 3 if the rating represents a downgrade from the previous examination.
  - — A Holding Company rating of Unsatisfactory.

We also revised the program to include procedures that reflect the above revisions.

—Scott M. Albinson

Managing Director

Examinations, Supervision, and Consumer Protection

Ratings: Developing, Assigning, and Presenting

This Handbook Section provides guidance in the following areas:

- Summarizing regulatory findings for the comprehensive Report of Examination (ROE) comments and conclusions.
- Assigning appropriate CAMELS and Compliance ratings.
- Meeting with association management and the board of directors to present the ROE findings.

LINKS

Program

Appendix A

Appendix B

COMMENTS AND CONCLUSIONS

There are unique factors to consider when developing conclusions, comments, and ratings for each CAMELS component and Compliance area. Each comment should be accurate, complete and concise.

Developing Report Comments

The following checklist will assist in developing individual CAMELS and Compliance comments for the ROE:

- Present the scope of the review.
- Clearly state conclusions.
- Clearly identify patterns, practices, trends, and their causes.
- Present comments in a meaningful order, discussing major strengths and weaknesses, with proper emphasis and tone accorded to individual topics. The severity of the problem will dictate its order of presentation. Consider how the problem affects the association's other activities and any mitigating circumstances.
- Identify substantive safety and soundness and compliance issues. See Examination Handbook Section 040 for a discussion of the characteristics of a substantive violation.

- Include the deficient underlying practices when you note patterns of regulatory noncompliance.
- Support conclusions with appropriate analysis and prepare an effective summary that does not lose the reader in detail.
- Assess the effect of examination findings on future operations.
- Include a discussion of corrective action where necessary.
- Identify actions needed to correct weaknesses, outstanding deficiencies, or violations as appropriate.
- Support the comments with work papers and other retained documents. Include information that provides a clear understanding of the overall condition, adequacy of management practices, causes of major problems, and recommendations for remedial action.
- Disclose the rating.

The Compliance comment should:

- Assess and record any association-identified regulatory violations or program deficiencies and distinguish among them as follows:

  — Those the association corrected.

  — Those the association is in the process of correcting.

  — Those the association has not corrected.

- Assess regulatory compliance violations or program deficiencies identified by the examination, but not found by the association or its self-assessment or audit processes. Address only violations deemed substantive in the ROE.

For 1- and 2-rated savings associations, if there are no findings of deteriorating performance or materially inadequate controls in a particular CAMELS or Compliance section, you may eliminate the individual narrative page and summarize the conclusions on the Examination Conclusions and Comments page in the ROE. You must address the association's compliance program in the Examination Conclusions and Comments if you do not use the Management page. See the ROE Instructions for additional guidance.

Primary Factors to Consider

Consider the following primary factors when developing your conclusions and ratings:

- Material items that relate to safety and soundness, and significant adverse findings for technology risks, or compliance, and the causes of those problems.
- An assessment of the compliance management program's performance.
- An assessment of the effectiveness of overall risk management.
- Regulatory violations and the reasons for any material patterns. A simple listing of violations is usually ineffective, particularly in the case of an isolated incident or error. While it is appropriate, in certain situations, to consider isolated violations, you should not bring them forward to the Examination Conclusions and Comments page unless they are significant.
- How your findings within each of the CAMELS and Compliance areas interrelate, affect the overall financial condition and safety and soundness of the association's operations, and reflect on the effectiveness of management.
- Material adverse findings outstanding from the prior examination and management's efforts to date to correct the problems.

Formulating an Overall Conclusion

As you complete individual report comments and compile work papers, you should begin to formulate an impression of the association's overall condition.

The development of a substantive overall conclusion requires that you:

- Review major findings from the examination (including trends).
- Consider the association's operating environment (both internal and external factors).
- Consider the need for supervisory monitoring or enforcement action.
- Convert ultimate determinations into ratings.
- Communicate results effectively.
- Facilitate the corrective action process.
- State conclusions and the overall evaluation in the ROE.

There are both objective and subjective factors involved in a comprehensive analysis of the association's present and expected future condition. You must weigh the significance of criticisms, deficiencies, and exceptions that may offset strengths. This requires reviewing CAMELS comments, compliance management comments, and other findings for interrelationships. Whenever a practice or other factor materially affects safety and soundness or compliance performance, you must look at both the present and potential future consequences.

One goal of the regulatory process is to prevent problems from developing or escalating in the future. Therefore, early identification of risk or weaknesses in management practices is key. Support any projections with adequate facts and analyses.

When developing a conclusion about the association's future prospects, consider:

- Existing systems, policies, and procedures.
- The business plan.
- Corrective action.
- Projections for operating performance.
- Use of information technology.
- Management effectiveness and ability to effect corrective actions.
- Market and economic factors.

One goal of the regulatory process is to prevent problems from developing or escalating in the future.

ASSIGNING RATINGS

After formulating the conclusions, you can begin the rating process. In a comprehensive examination, OTS rates a savings association in the following areas:

- **CAMELS components and composite ratings** – OTS uses the CAMELS rating system to evaluate a savings association's overall condition and performance by assessing six rating components. The six components are Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk. OTS then assigns each association a composite rating based on your assessment of its overall condition and level of supervisory concern.
- **Compliance rating** – OTS uses a Compliance Rating System that addresses general compliance with fair lending, consumer protection, and other public interest laws and regulations. This rating system is substantially equivalent to the FFIEC-approved interagency compliance rating system.

In order to assess management and the association's overall condition, you must adequately consider all areas and their interrelationships. This section briefly presents the main areas you must review in order to assign the six CAMELS component and composite ratings, and the Compliance rating. (See also the Appendices that follow this Section for detailed rating guidelines.)

You should follow the examination procedures within each of the chapters as required by the examination scope to develop the ratings.

OTS personnel use the ratings for a variety of purposes:

- To reflect trends for a particular association.
- To make comparisons with peers.
- To assess the condition of the industry.

The ratings help determine appropriate strategies including the following:

- Frequency and scope of off-site and on-site analysis.
- Enforcement actions.
- Meetings with association representatives.
- Analyzing applications (such as, merger, acquisitions, subordinated debt issuance), and notifications (such as, transactional website filings).

Because ratings determine a variety of critical decisions, a systematic and logical analysis is essential. While objective analysis and findings primarily determine ratings, there are some subjective factors, too.

CAMELS Rating System

The Uniform Financial Institutions Rating System (UFIRS) is the definitive statement on safety and soundness ratings. (See Appendix A.) Aggregate rating information enables the public and Congress to assess the condition of the savings and loan industry. Because the four banking regulatory agencies adopted the UFIRS, Congress and others can readily compare composite rating data for all types of insured savings associations.

This section expands on, or highlights certain parts of the policy statement as it applies to savings associations.

Composite Rating

> Composite ratings reflect a careful evaluation of an institution's managerial, operational, financial, and compliance performance.

The composite rating is a qualitative assessment by the agency of the association's condition and the agency's overall level of supervisory concern.

Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance. The six key components used to assess an institution's financial condition and operations are: capital adequacy, asset quality, management capability, earnings quantity and quality, the adequacy of liquidity, and sensitivity to market risk. The rating scale ranges from 1 to 5, with a rating of 1 indicating: the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile; and the level of least supervisory concern. A 5 rating indicates: the most critically deficient level of performance; inadequate risk management practices relative to the institution's size, complexity, and risk profile; and the greatest supervisory concern.

Although the composite rating assigned to the association should normally have a close relationship to the individual CAMELS component ratings, you should not derive the composite rating merely by computing an arithmetic average of the component ratings. Such a simplistic, mechanical approach will not reflect the true condition of the savings association; nor will it indicate the appropriate supervisory actions.

> The composite CAMELS rating, the CAMELS component ratings, and supporting documentation all play an important part in the regulatory process in support of any necessary enforcement action.

One of the principal objectives of the CAMELS rating process is to identify, through an overall assessment of the association as reflected in the composite rating, those associations that pose a risk of failure and merit more than normal supervisory attention. Thus, you should give more weight to individual CAMELS criteria that more strongly affect the condition and viability of the association. The composite CAMELS rating, the CAMELS component ratings, and supporting documentation all play an important part in the regulatory process in support of any necessary enforcement action.

The Examination Conclusions and Comments page, the CAMELS comments, and the work papers should support the composite rating. In the ROE, disclose the composite CAMELS and compliance ratings, refer to the definition of the assigned ratings, and explain the correlation between the association's circumstances and the ratings.

OTS uses an association's composite rating as one of the factors to determine whether OTS should designate the association as being in "troubled condition." OTS designates in troubled condition any association that has a composite CAMELS rating of 4 or 5. OTS defines other qualifiers of troubled condition in 12 CFR § 563.555. These associations are subject to greater regulatory scrutiny and restrictions, such as requirements to receive prior approval before engaging in certain activities.

When you examine an association in troubled condition, you should consult the regulatory profile, supervisory correspondence, the previous examination, and any other pertinent information to determine the operating restrictions to which an association is subject. You must then analyze the association's operations and ensure that it complies with all restrictions. For further information regarding operating restrictions, refer to Thrift Activities Handbook Section 370, Enforcement Actions.

The composite rating also supports OTS's differential regulation policy. The composite rating establishes both the OTS and the Federal Deposit Insurance Corporation (FDIC) fee assessment levels and determines the levels of supervisory oversight and restrictions. This policy provides tighter restrictions for thrifts with lower composite ratings and other factors, and is evident in the following guidance:

- Thrift Activities Handbook Section 370, Enforcement Actions.
- RB 3b (Growth Restrictions).
- OTS assessment regulation at 12 CFR § 502.10.
- OTS audit regulation at 12 CFR § 562.4.
- OTS transactions with affiliates regulation at 12 CFR § 563.41.
- OTS capital regulation at 12 CFR § 565.4.
- OTS directors' regulation at 12 CFR §§ 563.550 through 563.590.
- FDIC risk-based deposit insurance assessment regulation at 12 CFR Part 327.

Component Ratings

Generally, component ratings reflect examination findings and an examiner's assessment of an association's performance in the six key performance groups that are common to all associations. We highlight below, the UFIRS definition for each CAMELS component.

Capital Adequacy

Maintaining an adequate level of capital is a critical element for depository associations. While meeting regulatory capital requirements is a key factor in determining capital adequacy, the association's operations and risk position may warrant additional capital beyond the minimum regulatory requirements. You should determine whether capital is adequate in relation to the risk profile and operations of the association. In addition, you should evaluate capital levels in relation to future needs.

Maintaining an adequate level of capital is a critical element for depository associations.

Since maintaining a sufficient level of capital is critical for an association to maintain operations, you should appropriately weigh the importance of capital on the viability of the association when formulating the composite rating. You should also consider the association's dividend payout policy and practice. You should rate an association's capital adequacy considering all criteria cited in the UFIRS statement.

PCA Levels

In general, an association in any of the three lower-tier Prompt Corrective Action (PCA) categories warrants a 4 or 5 Capital component rating. A capital rating of 4 is appropriate if the association is undercapitalized or significantly undercapitalized but asset quality, earnings, or interest rate risk problems will not cause the association to become critically undercapitalized in the next 12 months. Also, a capital rating of 4 may be appropriate for an association that does not have sufficient capital based on its capital level compared with the risks present in its operations, even though the association may meet the minimum regulatory requirements.

An association warrants a 5 rating if it is "critically undercapitalized," or has significant asset quality problems, negative earning trends, or high interest rate risk exposure that will cause the association to become critically undercapitalized within the next 12 months.

See the Capital Chapter of this Handbook for more detailed instructions for reviewing capital adequacy.

Asset Quality

An accurate evaluation of an association's asset quality can be one of the most important products of the examination. The asset quality rating reflects the extent of credit risk associated with the loan and investment portfolios, real estate owned, other assets, and off-balance-sheet risks as well as the association's ability to manage those risks. The evaluation of an association's asset quality is dependent on the association's policies and procedures relating to loan underwriting and asset procurement, the proper monitoring and classification of assets, the nature of the risk inherent in the association's portfolios, and the adequacy of the association's valuation allowances.

When asset quality is in doubt because of excessive or inadequately controlled risk, the association's asset quality component rating should reflect this concern. In order to attain a 1 or 2 Asset Quality component rating, an association must fully control its credit risk. If an association has a high exposure to credit risk, it is not sufficient to demonstrate that the loans are profitable or that the association has not experienced significant losses in the near term. Management must demonstrate that it has identified credit risks, measured the potential exposure to loss, established systems to monitor such risk on an ongoing basis, and has taken adequate steps to limit and control those risks. Otherwise, a significant supervisory concern will exist relative to the association's asset quality.

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 activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk exposure levels and ensure that they have established appropriate policies, procedures, and practices. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.

Depending on the nature and scope of an association's activities, management practices may need to address some or all of the following risks:

- Credit
- Market
- Operating or transaction
- Reputation
- Strategic
- Compliance
- Legal
- Liquidity
- Other risks.

The following practices demonstrate sound management:

- Active oversight by the board of directors and management.
- Competent personnel.
- Adequate policies, processes, and controls taking into consideration the size and sophistication of the association.
- Maintenance of an appropriate audit program and internal control environment.
- Effective risk monitoring and management information systems.

This rating should reflect the board's and management's ability as it applies to all aspects of banking operations as well as other financial service activities in which the association is involved.

Consistent with the UFIRS definition, your assessment and rating of the management component must reflect the board of directors and management's ability and effectiveness in managing all aspects of an association's operations and risks, including the compliance management function. The Management rating component should also include its approach to compliance, its demonstrated capacity to administer and implement a compliance program using SMAART components.

Assigning a compliance rating of 3 identifies a less than satisfactory compliance position. When the compliance rating is 3, the Management component cannot receive a rating any higher than 2. Compliance ratings lower than 3 should further constrain the potential rating of the Management component. Generally, the level of substantive violations, programmatic deficiencies and OTS supervisory attention associated with compliance ratings of 4 or 5 are inconsistent with management performance under the CAMELS system of anything higher than a 3 for Management, and may be sufficient alone, or in combination with other management shortcomings to compel even lower ratings of Management.

Your assignment of the management rating must also consider the findings and conclusions for technology risk controls. The management rating should always reflect serious control deficiencies for technology risks.

Earnings

You must determine whether earnings are sufficient for necessary capital formation. An association should have minimum earnings sufficient to absorb losses without impairing capital. Quality (stability) and composition (source) of earnings are important criteria. The thrift cannot rely on income that is nonrecurring, such as gains on the sale of portfolio loans, to maintain profitability. You should consider the extent to which extraordinary items, such as nonrecurring securities transactions and tax effects contribute to net income.

In some cases, associations are able to sustain volume and stable earnings from noninterest sources of income; for example, mortgage banking operations. In these associations (as well as all other associations), you should use professional judgment and analyze the stability and sufficiency of noninterest earnings. This includes the association's ability to react quickly to changing economic conditions, such as a decline in mortgage originations.

In some cases, associations are able to sustain volume and stable earnings from noninterest sources of income.

You should consider the adequacy of transfers to the general and specific valuation allowances; if the association needs more allowances, earnings will be negatively affected.

You should also consider the association's operating risks to determine if its earnings position is stable and sufficient. For example, if an association's interest rate risk management is inadequate, the association's earnings may be adversely affected by a change in market interest rates.

Liquidity

OTS measures liquidity in relation to an association's level of liquid assets, its outside sources of funds, and the adequacy of its funds (or cash flow) management practices. Historically, most associations have held sufficient liquid assets. OTS-supervised associations generally rely upon liquidity available from secured lines of credit with the Federal Home Loan Banks (FHLBs). As long as the association's performance is sufficient to allow it to maintain a favorable credit standing with the FHLBs, and as long as the FHLBs also have adequate liquidity, associations can continue to confidently rely upon them for their liquidity needs.

Sensitivity to Market Risk

The UFIRS bases the sensitivity to market risk component rating on two dimensions:

- The association's level of market risk.
- The quality of the association's practices for managing market risk.

Because few savings associations have significant exposure to foreign exchange risk or commodity or equity price risks, OTS generally assesses interest rate risk as the only form of market risk. You must assess both dimensions and combine those assessments into a component rating.

You must base your conclusions about an association's level of interest rate risk – the first dimension for determining the Sensitivity component rating – primarily on the interest rate sensitivity of the association's net portfolio value (NPV). You must pay primary attention to two specific measures of risk: Interest Rate Sensitivity Measure and Post-shock NPV Ratio. (See the TB 13a glossary for definitions.)

- **Interest Rate Sensitivity Measure.** This measure by itself, may not give cause for supervisory concern when the association has a strong capital position. Because an association's risk of failure is inextricably linked to capital and, hence, to its ability to absorb adverse economic shocks, an association with a high level of economic capital, that is, NPV, may be able safely to support a high sensitivity measure.

- **Post-shock NPV Ratio.** This ratio is a more comprehensive gauge of risk than the sensitivity measure because it incorporates estimates of the current economic value of an institution's portfolio, in addition to the reported capital level and interest rate risk sensitivity. There are three potential causes of a low, that is, risky, post-shock NPV ratio:

  — Low reported capital

  — Significant unrecognized depreciation in the value of the portfolio

  — High interest rate sensitivity.

Although the first two situations may cause supervisory concern and receive attention under the portions of the examination devoted to evaluating Capital Adequacy, Asset Quality, or Earnings, they do not necessarily represent an interest rate risk problem. Only when an association's low post-shock NPV is, in whole or in part, caused by high interest rate sensitivity is there suggestion of an interest rate risk problem.

Refer to TB 13a (Section IV, Table 1) for the guidelines to determine the level of interest rate risk. Use these risk levels as starting points in your ratings assessments; however, you have broad discretion to exercise judgment. TB 13a provides these risk levels as guidance; they are not mandatory.

OTS produces quarterly estimates of the sensitivity measure of the post-shock NPV ratio for each association that files TFR Schedule CMR. You can find these estimates in the Interest Rate Risk Exposure Report for the association.

In drawing conclusions about the quality of an association's risk management practices – the second dimension of the Sensitivity component rating – you must assess all significant facets of the association's risk management process.

Consider the following eight factors when assessing the quality of an association's risk management practices:

- Quality of oversight by the board and senior management.
- Prudence of board-approved IRR limits.
- Adherence to IRR limits.
- Quality of system for measuring NPV sensitivity.
- Quality of system for measuring earnings sensitivity.
- Integration of risk management with decision-making.
- Investments and derivatives including risk management policies and procedures.
- Association's size, complexity, and risk profile.

Although TB 13a (Table 2) provides guidelines on how to combine your assessment of these two dimensions into a component rating, you must exercise judgment in assigning ratings based on the facts you encounter at each association. TB 13a (Section IV) provides a nonexhaustive list of factors you might consider in applying the Sensitivity rating guidelines to a particular association.

Thrift Performance Evaluation and CAMELS Rating Assignments

The Uniform Thrift Performance Report (UTPR) provides percentile rankings for many measures of association performance as compared to peer performance. Use the Risk Monitoring System (RMS) Query Builder to find the CAMELS composite ratings of other associations with similar key ratios. These tools are useful in comparing an association's performance with that of its peers to assign ratings that are consistent with associations having similar ratios. However, since the composite CAMELS rating is an indicator of the overall health and viability of an association, it is important that you rate associations on their absolute performance as well as against regional or state peer performance. Associations in some states or regions may perform better than peer averages or medians, but perform poorly in absolute terms or when compared with peer averages or medians of other regions. Peer performance in such cases would not necessarily reflect associations that were being operated in a safe and sound manner. Rather, those averages could reflect substandard performance. The CAMELS ratings should accurately reflect the condition of an association, regardless of local or regional peer performance.

> The mere fact that an association meets its minimum regulatory capital or other regulatory requirement does not guarantee that its condition is viable.

You cannot measure an association's performance solely in numbers. The mere fact that an association meets its minimum regulatory capital or other regulatory requirement does not guarantee that its condition is viable. Therefore, you must use professional judgment and consider both qualitative and quantitative criteria when analyzing an association's performance, taking into account:

- Quality of management and the board of directors.
- Quality and composition of the asset portfolio.
- Risks inherent in the business activities, including technology risks, and quality of risk management practices.
- Financial performance.

Further, since financial numbers are lagging indicators of an association's condition, you must also conduct a qualitative analysis of current and projected operations when assigning CAMELS ratings. You should weigh the analysis of quantitative and qualitative data to determine the rating for each CAMELS component.

Compliance Rating System

OTS adopted a Compliance Rating System substantially equivalent to the FFIEC-approved interagency compliance rating system. The FFIEC consumer compliance rating system states that a consumer compliance rating evaluates and weighs the following:

- The nature and extent of present compliance with consumer protection and civil rights statutes and regulations.
- The commitment of management to compliance and its ability and willingness to take the necessary steps to assure compliance.
- The adequacy of operating systems, including internal procedures, controls, and audit activities designed to ensure compliance on a routine and consistent basis.

The primary purpose of the Compliance Rating System is to help identify those associations whose compliance with civil rights, consumer protection and other public interest statutes and regulations, displays weaknesses requiring special supervisory attention and is cause for more than a normal degree of supervisory concern.

Assigning the Compliance Rating

In assigning a Compliance Rating, you must identify and evaluate all factors relevant to ensuring compliance with civil rights, consumer protection and other public interest statutes and regulations.

In general, these factors include:

- Implementation of a formal written compliance management program reliably covering OTS's SMAART components suitable to the size and operational complexity of the association.
- The commitment of the board and management, as evidenced by its ability and willingness to maintain compliance.
- Internal self-assessments and compliance reviews.
- Competency of management, as evidenced by the adequacy of operating systems, including internal procedures and controls designed to ensure compliance.
- Appropriate compliance training programs.
- The nature and extent of violations (including repeat violations) and deficiencies in actual compliance performance as a measure of the effectiveness of management's efforts.

The Compliance Rating System is a scale of 1 through 5, in increasing order of supervisory concern.

Other factors unique to specific situations will require attention if you determine they significantly affect the overall effectiveness of an association's compliance efforts.

The Compliance Rating System is a scale of 1 through 5, in increasing order of supervisory concern. A rating of 1 indicates excellence, while a rating of 5 represents the lowest, most critically deficient level of performance and the highest level of supervisory concern. The Compliance Rating System is a single-value rating system. The single rating value assigned reflects overall compliance performance and you must substantiate the rating by the contents of the ROE and the examination work papers. Characteristics of the five Compliance Ratings available to the examiner will conform to the rating descriptions in Appendix B. However, as these descriptions are a composite, not all characteristics will be present at every institution. You must apply this guidance to capture an accurate overall evaluation of the association's compliance management performance for the examination period, keeping in mind the policy to encourage self-identifying and self-correcting controls.

See Appendix B for a detailed description of the characteristics of the five Compliance Ratings.

Consistency in Rating Assignments

It is essential that OTS apply ratings on a nationally consistent basis. Inconsistencies in assigning Compliance and CAMELS component or composite ratings may result in confusion and degrade the integrity of the supervisory process. With consistently applied ratings, OTS can compare the condition of the association between the previous examination and the most recent examination. Furthermore, and particularly with CAMELS ratings, you can compare associations on an intraregional and a national basis using RMS Query Builder reports sorted by key ratios. To ensure consistency in the rating process, you must have a thorough understanding of the criteria to assign the different Compliance and CAMELS component and composite ratings.

Maintaining and Updating the Ratings

> Deterioration or significant changes in the association's operations or condition, or noncompliance with laws and regulations, may indicate a need for some special supervisory attention.

It is essential that regional offices monitor new developments for each association and update the ratings, as needed, so that the rating is always a current indicator of the association's condition. (Refer to Examination Program 070 for off-site ratings procedures.) Maintaining these ratings requires periodic monitoring with an emphasis on the criteria supporting the CAMELS ratings for the association. For this reason, it is imperative that you document the significant points supporting the CAMELS rating.

Deterioration or significant changes in the association's operations or condition, or noncompliance with laws and regulations, may indicate a need for enhanced supervisory attention. Supervisory attention may include a telephone inquiry or written request for additional information, a limited examination, or a regular examination. Any changes in the criteria that support the current ratings or any new developments may require a change in the CAMELS ratings and the supervisory treatment needed.

Since ratings affect the association's assessment and supervisory treatment, OTS must keep them current. Analyze and adequately document any updates to the ratings. The rating OTS reports to an association must always be the most recent rating based on all sources of information.

Documentation and Support

Given the importance of the ratings, it is critical to clearly show and support how you determined these ratings. Include this documentation in the work papers. Discuss adverse findings in the individual sections of the ROE. Summarize overall findings and conclusions in the Examination Conclusions and Comments page of the ROE. For CAMELS ratings in particular, you should review ROE ratios, UTPR schedules, and customized RMS reports and use them to concisely document and support the analysis. You may also find these reports useful in assimilating and reviewing work paper conclusions and organizing your thoughts before drafting the ROE.

Disclosure of Ratings

OTS discloses composite and component ratings to each association's management and board of directors. Disclosure of the CAMELS component ratings encourages a more complete and open discussion of examination findings and recommendations between examiners and association management. Further, disclosure of the CAMELS component and Compliance ratings in addition to the composite rating provides management with a better understanding of how OTS derives the composite rating. Disclosure also enables management to better address any weaknesses in specific areas before OTS finds it necessary to downgrade the association's overall composite rating.

Obtain sufficient concurrence from regional management, so that the ratings you disclose are final, or subject to revisions only in rare instances. If the ratings are subject to further review, let association management know that the ratings are not final.

You should disclose the elements considered in assigning each component rating and those considered in assigning the overall rating. You should indicate that a careful evaluation of the association's managerial, operational and financial performance and their compliance with laws and regulations determines the composite rating.

You must disclose the assigned composite rating in accordance with OTS's ROE instructions. Add the component rating to each ROE core component page. The Examination Conclusions and Comments page should provide a concise narrative statement of the major findings of the examination. In addition, the Examination Conclusions and Comments page should clearly state how the examination findings within each of the CAMELS and Compliance areas interrelate and affect the overall financial condition and safety and soundness of the association's operations.

Supervisory Letter

When the regional office changes the CAMELS composite rating or the Compliance rating off-site, they send a supervisory letter to the board of directors to notify them of the change. A change in rating may result from changes in the association's operating strategies or conditions. An on-site review may be appropriate when conditions warrant a downgrade in rating. When the CAMELS composite rating changes, we advise evaluating the need to change all six CAMELS component ratings. Include in the supervisory letter a prohibition against outside disclosure and explain why the rating changed.

MEETINGS WITH MANAGEMENT AND THE BOARD OF DIRECTORS

You must disclose CAMELS composite and component ratings and the Compliance rating at exit conferences with senior management and, when appropriate, the board of directors. You should obtain sufficient concurrence with the ratings from regional management, so that the component ratings disclosed are final, or subject to revisions only in rare instances. If the ratings are subject to further review, you should disclose to management and the board that the ratings are not final. Each region has office procedures to implement this policy.

Management Discussions

During the discussion with management, you should discuss the criteria you considered in assigning each rating as well as the overall composite rating and the compliance rating. You should indicate that you based the composite rating on a careful evaluation of the association's managerial, operational and financial performance, and compliance with laws and regulations. You should clarify that you did not base the composite rating on an arithmetic average of the components, but on a qualitative analysis of the criteria comprising each component, the interrelationship between components, and, more importantly, the overall level of supervisory concern.

The quality of management is the single most important element in the successful operation of an association, and is usually the factor that is most indicative of how well the association identifies, measures, monitors, and controls risk. For this reason, you should take sufficient time to explain to senior management and, when appropriate, to the board of directors, the criteria you considered in assigning the management component rating, and the meaning of the rating. Your written comments in support of the management rating should include an assessment of the effectiveness of existing processes to identify, measure, monitor, and control risk. Finally, you should remind management that the ratings disclosed in the examination report remain subject to the confidentiality rules imposed by 12 CFR Part 510 of the OTS Regulations. This includes the verbal disclosures made at the conclusion of the examination.

> The quality of management is the single most important element in the successful operation of an association.

Meetings with the Board of Directors

In addition to meeting with management, OTS encourages you to meet with the boards of directors. Meetings between regulatory staff and the board of directors – the individuals ultimately responsible for a savings association's affairs – serve a variety of functions. They provide opportunity for interaction, and they facilitate long-term communication, especially important when the regulatory process reveals significant adverse information. Meetings help keep directors and regulators mutually informed by providing them an opportunity to discuss any of the following items:

- The examination process and findings.

- The association, its functions, and strategic plans and goals.
- The general financial environment.
- Industry-related concerns.

Meetings give regulators an opportunity to obtain commitments from the board for corrective action.

Types of Meetings

There are two primary types of meetings between regulators and the board: **regular** – those relating to examinations; and **special** – not primarily for presenting examination findings. However, a meeting can serve multiple purposes. For example, a regular meeting can serve to acquaint regulators with the board, enhance communication, and present findings.

Regular Meetings

A regular meeting can result from a regular or limited examination. Generally held at the conclusion of the examination, its primary purpose is to discuss findings and agree on corrective action. These meetings can also enhance the directors' understanding of the regulatory process, establish a rapport, and build lines of communication with regulators.

You should consider attending a regularly scheduled board meeting that occurs during an examination. The purpose is not necessarily to discuss findings although it may be an opportunity to discuss scope and preliminary findings. The main objective; however, is to observe the board in action and establish a rapport.

You should hold a meeting if you note adverse trends, increased risk profile, or other matters that need the board's attention. If no such issues exist, you may honor any request from management to forgo a meeting with the board. You must meet with the board of directors if the association has:

- A CAMELS composite or Compliance rating of 4 or 5.
- A CAMELS composite or Compliance rating of 3 if the rating represents a downgrade from the previous examination.
- A Holding Company rating of Unsatisfactory.

Generally, you should meet with the boards of all 3-rated associations. However, you may, with the concurrence of the field manager, determine it is not necessary to meet if the 3 rating is not a downgrade from a prior examination.

Sometimes you might schedule a meeting with the board of an association that does not have an adverse rating. This is appropriate when you note adverse trends, increased risk profile, or other matters that you need to bring to the board's attention. If no issues exist, you should honor any request from management to forgo a meeting.

If an association's assets exceed $1 billion, you should schedule a meeting with the board regardless of adverse trends. The field manager must concur with any decision to forgo a meeting.

While you normally meet after the examination, you could arrange a regular meeting during the last week. This is appropriate if you have already discussed the examination results with management. Your meeting can also coincide with the board's next regularly scheduled meeting. You can mutually agree on another time to meet as long as that date is within 60 days of completing the examination. Also when scheduling, consider whether directors would benefit from receiving a copy of the ROE before the meeting.

Participation

When meeting with the board, you should meet with the entire board to ensure all directors are aware of regulatory findings and commitments to correct deficiencies. If all directors cannot attend, you can meet with a group, such as the audit, examination, or executive committee if:

- Outside directors are present.
- There are no material or adverse findings.
- The circumstances do not require a full board.

Honorary directors can participate in meeting discussions, but may not vote. Any person or organization connected with the association, auditor, or holding company representative can attend the meeting upon board resolution. However, you can excuse such people if appropriate. As a rule, state supervisory authorities should attend meetings with the boards of state-chartered institutions.

Special Meetings

Reasons to schedule a special meeting include the following:

- To effect a supervisory action, such as a supervisory agreement or cease and desist order.
- To gather information in order to act on a proposal, application, or request by the association.
- To discuss an association's progress toward corrective action.
- To become acquainted following a change in directorate or a change in regulatory staff.
- To comply with directorate's request to meet.

Meeting Preparation, Presentation, and Documentation

Schedule a mutually acceptable, convenient date and time to hold the meeting. Prepare yourself thoroughly when meeting with the directorate. Conduct yourself professionally and prepare sufficient documentation to ensure appropriate follow-up. A successful meeting will include all of the following steps:

- **Preparation**

  — Ensure that the scheduling and selection of attendees satisfies the meeting's goal.

  — Choose attendees and determine their responsibilities.

  — Select a chairperson.

  — Determine time and location.

  — Develop an agenda.

  — Notify participants of the meeting and its purpose.

  — Meet with regulatory staff participants to discuss the agenda and other related issues.

  — Prepare and organize supporting data, including comparative figures and ratios that indicate trends and graphs to illustrate significant points or trends.

  — Prepare any handouts or overheads for presentation.

- **Presentation**

  — Conduct the meeting in a professional, objective fashion.

  — Present the agenda and follow it within reason.

  — Establish good communication and maintain creditability.

  — Encourage directors' involvement and solicit questions.

  — Answer questions accurately. When unable to do so, tell the board you will find an answer. You may need to refer inquiries to the OTS regional or Washington office.

  — Obtain commitment from board to correct deficiencies, if appropriate.

- **Documentation**

  — Evaluate and document results of the meeting.

  — Prepare a memorandum to record results, date, time, location, and participant's names and titles.

  — Describe the items discussed, the board's reactions, and any commitments for corrective action.

  — If the board promises corrective action, send the memorandum to them for concurrence.

  — At the conclusion of any meeting conducted by the board (rather than the regulators), you should ask for a copy of the minutes and review them for accuracy.

  — Keep a copy of the post-meeting memorandum and agenda in the appropriate supervisory file.

  — Amend the association's regulatory profile to reflect any changes or future commitments as a result of the meeting. See Examination Handbook Section 040.

REFERENCES

Code of Federal Regulations (12 CFR)

OTS Regulations

§502.10	Assessments
§562.4	Audit of Savings Associations and Holding Companies
§563.41	Loans and Other Transactions With Affiliates
§563.550	Additions of Directors and Employment of Senior Executive Officers
§565.4	Capital Measures and Capital Category Definitions

FDIC Regulations

Part 327	Assessments

Office of Thrift Supervision Bulletins

RB 3b	Policy Statement on Growth for Insured Institutions
RB 18	General Enforcement Policy Series
TB 13a	Management of Interest Rate Risk, Investment Securities, and Derivative Activities

Other References

OTS Report of Examination Instructions

FFIEC Press Release, Uniform Financial Institutions Rating System, December 19, 1996

OTS Transmittal 166: Regulatory Citations to UFIRS

Ratings: Developing, Assigning, and Presenting Program

EXAMINATION OBJECTIVES

To formulate conclusions regarding the risks, condition, trends, management practices, and future prospects of the savings association.

To formulate conclusions on the safety and soundness and regulatory compliance of the thrift and propose supervisory action, if needed.

To evaluate the performance of the compliance management program and evaluate any self-assessment reviews.

To effectively communicate conclusions and recommendations, both orally and in writing, in the Report of Examination according to the ROE Instructions and plain language principles.

To consider all significant financial, operational, and compliance performance measures for a savings association and assign CAMELS and Compliance ratings that accurately reflect the association's condition and viability.

To clearly support the CAMELS and Compliance ratings in the examination report and enable OTS to initiate corrective action with the association's directors and management.

To provide the association's management and the board of directors with CAMELS and Compliance ratings that signifies the OTS's assessment of the association's overall condition.

To record management's response to examination findings, conclusions, and proposed corrective action.

EXAMINATION PROCEDURES

WKP. REF.

1. Review analyses, comments, exceptions, and conclusions in the work papers for each CAMELS and Compliance area, and perform the following:

   - Resolve any contradictory conclusions. Support all conclusions with facts obtained during the examination.
   - Determine the significance of the findings related to safety and soundness and overall regulatory compliance.

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- Discuss findings with appropriate institution personnel and verify conclusions as appropriate.

2. Review the draft CAMELS and Compliance comments. Review assisting examiners' comments on management's self-assessment efforts and record of self-correcting compliance deficiencies. Talk with assisting examiners about their overall observations and findings applicable to the comments and determine whether conclusions are reasonable. Consider the interrelationships between findings noted for each CAMELS component and Compliance. If necessary, make adjustments to ensure that comments are comprehensive and to eliminate any duplication. If the EIC is aware of other criteria that are not known to assisting personnel, the EIC should determine if these criteria are relevant and whether or not to include the comments.

3. Revise CAMELS and Compliance comments so that they fairly represent examination results according to ROE instructions. Ensure conclusions are well supported in work papers and comments include any significant items noted in work papers. The tone and content of each comment should be concise and appropriate, as outlined in the Handbook.

4. Review the proposed corrective actions related to any violation or exception to ensure it is appropriate.

5. Review the preliminary CAMELS component and Compliance ratings and meet with assisting examiners. Follow definitions and instructions pertinent to the rating system to ensure national consistency. Discuss the recommendations with assistant examiners to ensure the accuracy of their interpretations. Ensure that assistant examiners provided well-supported conclusions and opinions. Ensure that assistant examiners consistently applied the standard criteria set forth in this Handbook

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Section for determining and weighing the CAMELS and Compliance criteria and assigning the ratings.

6. If necessary, adjust the CAMELS component and Compliance ratings so that they accurately and objectively present the association's performance in each area. Document the basis for each rating. Include the ROE ratios as well as any other pertinent ratios. Also include the most significant points supporting each rating. Review CAMELS comments again to ensure that they are consistent with the component ratings assigned.

   Consider the impact of findings for compliance management performance and technology risk controls in rating the Management component.

7. Make an overall assessment of the association and its future prospects in terms of risk, including technology risk, and adequacy of management and its system for risk and compliance management.

8. Prepare the Examination Conclusions and Comments page. Refer to the ROE Instructions for a list of elements you should include on this page. Ensure the report is written in plain language.

9. Determine the CAMELS composite rating and Compliance rating by weighing the importance of various criteria used to develop conclusions. To ensure national consistency, you should follow the rating instructions in the UFIRS Statement following this Handbook Section. Clearly support the composite rating with the facts and comments within the ROE.

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10. Review the Examination Conclusions and Comments page to ensure the tone and content supports the assigned composite rating. Finalize the CAMELS and Compliance ratings and comments after a thorough review. Ensure that the assistant examiner correctly completed the EDS/ROE ratings section, including the Technology Risk Controls (TRC) flag.

11. Discuss findings with management, typically the CEO. We recommend that you use an agenda. Discuss at least the following topics:

- The purpose of the meeting.
- All items that you might include in the examination report.
- Overall conclusions regarding the institution.
- Management's corrective action responses.
- Composite and component ratings.

12. After the meeting, correct any items in the ROE that are inaccurate, misleading, or misinterpreted.

13. The Matters Requiring Board Attention page should include corrective actions, if appropriate. These include specific recommendations to correct deficiencies and violations listed in the report. Obtain a firm commitment for improvement of corrective action.

    You may also include on this page recommendations for: supervisory agreements, consent agreements, cease-and-desist orders, receiverships, conservatorships, civil money penalties, compliance plans pursuant to 12 CFR Part 570, Appendix A and Appendix B, and criminal referrals to appropriate agencies. For suspected violations of criminal statutes, refer to Thrift Activities Handbook Section 360, Fraud/Insider Abuse.

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14. Provide any information to the regional office that will be useful for revising the Regulatory Profile.

15. Prepare the ROE cover page letter, if necessary, in accordance with regional office policy.

16. Prepare to meet with the board of directors regarding findings.

17. Ensure that your review meets the Objectives of this Handbook Section.

Off-Site Ratings

Supervisory managers, analysts, or other staff should complete the following procedures as applicable when analyzing and updating CAMELS and Compliance ratings off-site.

Note: You should use the Type 46 Limited Examination Report to make any off-site rating updates.

1. Review the most recent examination report and the Regulatory Profile to identify areas of concern.

2. Review the association's compliance management program and the reports made as a result of the association's self-assessment process.

3. Analyze reported financial information to determine current trends and any new areas of concern, with an emphasis on the period since the last examination.

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4. Review any applications and notifications the association submitted since the last rating to determine whether there are any material changes in the structure or business plan.

5. Review correspondence between the association and OTS to learn the status of significant issues arising since the most recent examination. Verify, to the extent possible, through a review of the financial statements and other reports that the association is correcting any problem areas.

6. Review the most recent external audit report, the certified public accountant's management letter addressing internal control issues, and the association's response to that letter to determine if management corrected all reported internal control deficiencies.

7. If necessary, contact the association to verify specific facts or address concerns.

8. Identify any changes in the association's condition and operating practices. Determine if a change in a CAMELS component or composite rating, or Compliance rating, more appropriately reflects the condition of the association.

9. Determine the need for and recommend, if necessary, a regular examination or a limited on-site examination of areas that you cannot adequately analyze off-site.

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10. Recommend any change in the CAMELS component or composite ratings, or Compliance rating, to the supervisory manager or other appropriate manager in the regional office. Support any recommendation for change with a narrative memorandum and documented analysis explaining and supporting the reasons for the change.

11. If the regional office approves a change in a composite or component CAMELS rating, or Compliance rating, prepare a supervisory letter or memorandum to the association's board of directors to inform them of the change in the rating. The memo should explain the reasons for the change and any resulting consequences. The memorandum should also contain a definition of the new rating assigned and standard language prohibiting disclosure of the rating.

12. Enter the new rating(s) in the EDS ratings section and make certain they are correct.

13. Update the Regulatory Profile with any other appropriate information.

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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FFIEC Press Release, December 19, 1996 [61 FR 67021]

UNIFORM FINANCIAL INSTITUTIONS[1] RATING SYSTEM

Introduction

The Uniform Financial Institutions Rating System (UFIRS) was adopted by the Federal Financial Institutions Examination Council (FFIEC) on November 13, 1979. Over the years, the UFIRS has proven to be an effective internal supervisory tool for evaluating the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special attention or concern. A number of changes, however, have occurred in the banking industry and in the Federal supervisory agencies' policies and procedures which have prompted a review and revision of the 1979 rating system. The revisions to UFIRS in 1997 included the addition of a sixth component addressing sensitivity to market risks, the explicit reference to the quality of risk management processes in the management component, and the identification of risk elements within the composite and component rating descriptions.

The revisions to UFIRS were not intended to add to the regulatory burden of institutions or require additional policies or processes. The revisions are intended to promote and complement efficient examination processes. The revisions have been made to update the rating system, while retaining the basic framework of the original rating system.

The UFIRS takes into consideration certain financial, managerial, and compliance factors that are common to all institutions. Under this system, the supervisory agencies endeavor to ensure that all financial institutions are evaluated in a comprehensive and uniform manner, and that supervisory attention is appropriately focused on the financial institutions exhibiting financial and operational weaknesses or adverse trends.

The UFIRS also serves as a useful vehicle for identifying problem or deteriorating financial institutions, as well as for categorizing institutions with deficiencies in particular component areas. Further, the rating system assists Congress in following safety and soundness trends and in assessing the aggregate strength and soundness of the financial industry. As such, the UFIRS assists the agencies in fulfilling their collective mission of maintaining stability and public confidence in the nation's financial system.

Overview

Under the UFIRS, each financial institution is assigned a composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations. These

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1 For purposes of this rating system, the term "financial institution" refers to those insured depository institutions whose primary Federal supervisory agency is represented on the Federal Financial Institutions Examination Council (FFIEC). The agencies comprising the FFIEC are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. The term "financial institution" includes Federally supervised commercial banks, savings and loan associations, mutual savings banks, and credit unions.

component factors address the adequacy of capital, the quality of assets, the capability of management, the quality and level of earnings, the adequacy of liquidity, and the sensitivity to market risk. Evaluations of the components take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile.

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

The composite rating generally bears a close relationship to the component ratings assigned. However, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors comprising that component and its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the financial institution. 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 activities or products, is an important factor in evaluating a financial 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 operations is also taken into account when assigning each component rating. It is recognized, however, that appropriate management practices vary considerably among financial institutions, depending on their size, complexity, and risk profile. For less complex institutions engaged solely in traditional banking activities and whose directors and senior managers, in their respective roles, are actively involved in the oversight and management of day-to-day operations, relatively basic management systems and controls may be adequate. At more complex institutions, on the other hand, detailed and formal management systems and controls are needed to address their broader range of financial activities and to provide senior managers and directors, in their respective roles, with the information they need to monitor and direct day-to-day activities. All institutions are expected to properly manage their risks. For less complex institutions engaging in less sophisticated risk taking activities, detailed or highly formalized management systems and controls are not required to receive strong or satisfactory component or composite ratings.

Foreign Branch and specialty examination findings and the ratings assigned to those areas are taken into consideration, as appropriate, when assigning component and composite ratings under UFIRS. The specialty examination areas include: Compliance, Community Reinvestment, Government Security Dealers, Information Systems, Municipal Security Dealers, Transfer Agent, and Trust.

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

COMPOSITE RATINGS

Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance. The six key components used to assess an institution's financial condition and operations are: capital adequacy, asset quality, management capability, earnings quantity and quality, the adequacy of liquidity, and sensitivity to market risk. The rating scale ranges from 1 to 5, with a rating of 1 indicating: the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile; and the level of least supervisory concern. A 5 rating indicates: the most critically deficient level of performance; inadequate risk management practices relative to the institution's size, complexity, and risk profile; and the greatest supervisory concern. The composite ratings are defined as follows:

Composite 1

Financial institutions in this group are sound in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the board of directors and management. These financial institutions are the most capable of withstanding the vagaries of business conditions and are resistant to outside influences such as economic instability in their trade area. These financial institutions are in substantial compliance with laws and regulations. As a result, these financial institutions exhibit the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile, and give no cause for supervisory concern.

Composite 2

Financial institutions in this group are fundamentally sound. For a financial institution to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the board of directors' and management's capabilities and willingness to correct. These financial institutions are stable and are capable of withstanding business fluctuations. These financial institutions are 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

Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will 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. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

Composite 4

Financial institutions in this group generally exhibit unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the institution's size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the deposit insurance fund. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

Composite 5

Financial institutions in this group exhibit extremely unsafe and unsound practices or conditions; exhibit a critically deficient performance; often contain inadequate risk management practices relative to the institution's size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed in order for the financial institution to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the deposit insurance fund and failure is highly probable.

COMPONENT RATINGS

Each of the component rating descriptions is divided into three sections: an introductory paragraph; a list of the principal evaluation factors that relate to that component; and a brief 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 between components. The listing of evaluation factors for each component rating is in no particular order of importance.

Capital Adequacy

A financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution's activities will determine the extent to which it may be necessary to maintain capital at levels above required regulatory minimums to properly reflect the potentially adverse consequences that these risks may have on the institution's capital.

The capital adequacy of an institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of capital and the overall financial condition of the institution.
- The ability of management to address emerging needs for additional capital.
- The nature, trend, and volume of problem assets, and the adequacy of allowances for loan and lease losses and other valuation reserves.
- Balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities.
- Risk exposure represented by off-balance sheet activities.
- The quality and strength of earnings, and the reasonableness of dividends.
- Prospects and plans for growth, as well as past experience in managing growth.
- Access to capital markets and other sources of capital, including support provided by a parent holding company.

Ratings

1 A rating of 1 indicates a strong capital level relative to the institution's risk profile.

2 A rating of 2 indicates a satisfactory capital level relative to the financial institution's risk profile.

3 A rating of 3 indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements.

4 A rating of 4 indicates a deficient level of capital. In light of the institution's risk profile, viability of the institution may be threatened. Assistance from shareholders or other external sources of financial support may be required.

5 A rating of 5 indicates a critically deficient level of capital such that the institution's viability is threatened. Immediate assistance from shareholders or other external sources of financial support is required.

Asset Quality

The asset quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, and other assets, as well as off-balance sheet transactions. The ability of management to identify, measure, monitor, and control credit risk is also reflected here. The evaluation of asset quality should consider the adequacy of the allowance for loan and lease losses and weigh the exposure to counterparty, issuer, or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of an institution's assets, including, but not limited to, operating, market, reputation, strategic, or compliance risks, should also be considered.

The asset quality of a financial institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices.
- The level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance sheet transactions.
- The adequacy of the allowance for loan and lease losses and other asset valuation reserves.
- The credit risk arising from or reduced by off-balance sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit.
- The diversification and quality of the loan and investment portfolios.
- The extent of securities underwriting activities and exposure to counterparties in trading activities.
- The existence of asset concentrations.
- The adequacy of loan and investment policies, procedures, and practices.
- The ability of management to properly administer its assets, including the timely identification and collection of problem assets.
- The adequacy of internal controls and management information systems.
- The volume and nature of credit documentation exceptions.

Ratings

1 A rating of 1 indicates strong asset quality and credit administration practices. Identified weaknesses are minor in nature and risk exposure is modest in relation to capital protection and management's abilities. Asset quality in such institutions is of minimal supervisory concern.

2 A rating of 2 indicates satisfactory asset quality and credit administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities.

3 A rating of 3 is assigned when asset quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is generally a need to improve credit administration and risk management practices.

4 A rating of 4 is assigned to financial institutions with deficient asset quality or credit administration practices. The levels of risk and problem assets are significant, inadequately controlled, and subject the financial institution to potential losses that, if left unchecked, may threaten its viability.

5 A rating of 5 represents critically deficient asset quality or credit administration practices that present an imminent threat to the institution's viability.

Management

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 activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's activities, management practices may need to address some or all of the following risks: credit, market, operating or transaction, reputation, strategic, compliance, legal, 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 taking into consideration the size and sophistication of the institution; maintenance of an appropriate audit program and internal control environment; and effective risk monitoring and management information systems. This rating should reflect the board's and management's ability as it applies to all aspects of banking operations as well as other financial service activities in which the institution is involved.

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

- The level and quality of oversight and support of all institution activities by the board of directors and management.
- 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 initiation of new activities or products.
- The adequacy of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities.
- The accuracy, timeliness, and effectiveness of management information and risk monitoring systems appropriate for the institution's size, complexity, and risk profile.
- The adequacy of audits and internal controls to: promote effective operations and reliable financial and regulatory reporting; safeguard assets; and ensure compliance with laws, regulations, and internal policies.
- Compliance with laws and regulations.
- Responsiveness to recommendations from auditors and supervisory authorities.
- Management depth and succession.
- The extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority.
- Reasonableness of compensation policies and avoidance of self-dealing.
- Demonstrated willingness to serve the legitimate banking needs of the community.
- The overall performance of the institution and its risk profile.

Ratings

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

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

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

4 A rating of 4 indicates deficient management and board performance or risk management practices that are inadequate considering the nature of an institution's 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 preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.

5 A rating of 5 indicates critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

Earnings

This rating reflects not only the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings. The quantity as well as the quality of earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses and require additions to the allowance for loan and lease losses, or by high levels of market risk that may unduly expose an institution's earnings to volatility in interest rates. The quality of earnings may also be diminished by undue reliance on extraordinary gains, nonrecurring events, or favorable tax effects. Future earnings may be adversely affected by an inability to forecast or control funding and operating expenses, improperly executed or ill-advised business strategies, or poorly managed or uncontrolled exposure to other risks.

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

- The level of earnings, including trends and stability.
- The ability to provide for adequate capital through retained earnings.

- The quality and sources of earnings.
- The level of expenses in relation to operations.
- The adequacy of the budgeting systems, forecasting processes, and management information systems in general.
- The adequacy of provisions to maintain the allowance for loan and lease losses and other valuation allowance accounts.
- The earnings exposure to market risk such as interest rate, foreign exchange, and price risks.

Ratings

1 A rating of 1 indicates earnings that are strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.

2 A rating of 2 indicates earnings that are satisfactory. Earnings are sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution's level of earnings is adequate in view of the assessment factors listed above.

3 A rating of 3 indicates earnings that need to be improved. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.

4 A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. Institutions so rated may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.

5 A rating of 5 indicates earnings that are critically deficient. A financial institution with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.

Liquidity

In evaluating the adequacy of a financial institution's liquidity position, consideration should be given to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds management practices relative to the institution's size, complexity, and risk profile.

In general, funds management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds management practices should ensure that liquidity is not maintained at a high cost, or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

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

- The adequacy of liquidity sources compared to present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition.
- The availability of assets readily convertible to cash without undue loss.
- Access to money markets and other sources of funding.
- The level of diversification of funding sources, both on- and off-balance sheet.
- The degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer term assets.
- The trend and stability of deposits.
- The ability to securitize and sell certain pools of assets.
- The capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds management strategies, liquidity policies, management information systems, and contingency funding plans.

Ratings

1 A rating of 1 indicates strong liquidity levels and well-developed funds management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

2 A rating of 2 indicates satisfactory liquidity levels and funds management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds management practices.

3 A rating of 3 indicates liquidity levels or funds management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds management practices.

4 A rating of 4 indicates deficient liquidity levels or inadequate funds management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.

5 A rating of 5 indicates liquidity levels or funds management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

Sensitivity to Market Risk

The sensitivity to market risk component reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital. When evaluating this component, consideration should be given to: management's ability to identify, measure, monitor, and control market risk; the institution's size; the nature and complexity of its activities; and the adequacy of its capital and earnings in relation to its level of market risk exposure. For many institutions, the primary source of market risk arises from nontrading positions and their sensitivity to changes in interest rates. In some larger institutions, foreign operations can be a significant source of market risk. For some institutions, trading activities are a major source of market risk.

Market risk is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign exchanges rates, commodity prices, or equity prices.
- The ability of management to identify, measure, monitor, and control exposure to market risk given the institution's size, complexity, and risk profile.
- The nature and complexity of interest-rate risk exposure arising from nontrading positions.
- Where appropriate, the nature and complexity of market risk exposure arising from trading and foreign operations.

Ratings

1 A rating of 1 indicates that market risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of market risk taken by the institution.

2 A rating of 2 indicates that market risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk management practices are satisfactory for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of market risk taken by the institution.

3 A rating of 3 indicates that control of market risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk management practices need to be improved given the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital may not adequately support the degree of market risk taken by the institution.

4 A rating of 4 indicates that control of market risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk management practices are deficient for the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of market risk taken by the institution.

5 A rating of 5 indicates that control of market risk sensitivity is unacceptable or that the level of market risk taken by the institution is an imminent threat to its viability. Risk management practices are wholly inadequate for the size, sophistication, and level of market risk accepted by the institution.

COMPLIANCE RATING SCALE

OTS defines the five-point Compliance Ratings as follows:

Rating 1

An association in this category is in a strong compliance management position. The compliance management program completely and reliably covers all six SMAART components and applies best practices in developing, maintaining and executing that program. The institution conducts thorough and reliable self-assessments in accordance with a well-conceived risk schedule and promptly corrects any violations or operational deficiencies. System records are complete. Review reports are well prepared and integral to management and board decisions. Training maintains staff compliance expertise. Monitoring controls are strong resulting in any compliance violations being infrequent, self-identified and timely corrected. There is no evidence of prohibited discrimination, reimbursable violations, or systemic deficiencies resulting in repeated substantive violations. The institution's compliance management gives no cause for supervisory concern.

Rating 2

An association in this category is in an adequate compliance management position. Management has a demonstrated capacity to administer an effective compliance program that satisfactorily addresses the SMAART components. Self-assessments may or may not be conducted, but in any case are not thorough enough, or their results adequately assimilated, to be a sufficient basis upon which to grade compliance management performance. Separate evaluation of the other SMAART components by the examiner supports favorable findings of compliance management capabilities and performance given the institution's size, business strategy, operational complexity and risk profile. Some areas of programmatic weakness or areas for improvement may occur that either had not been self-identified or were self-identified but not promptly self-corrected. Readily attainable enhancements to the institution's compliance program and/or the establishment of additional review/audit procedures will eliminate performance deficiencies. Although there may be technical compliance violations and limited infrequent substantive violations readily remedied, there is no evidence of prohibited discrimination, reimbursable violations, or programmatic deficiencies resulting in repeated substantive violations.

Rating 3

An association in this category is in a less than satisfactory compliance position requiring a further supervisory review. Management does not conduct reliable self-assessments, and the other components of the compliance management program do not perform sufficiently well to prevent systemic or repeated non-technical compliance violations. Overall implementation of the SMAART components is not up to the standards expected of institutions of similar capacity. Violations may be numerous. Substantive regulatory violations were either not self-identified or were not fully remedied as part of the institution's regular monitoring or response processes. There is no finding of prohibited discrimination. By identifying an institution with marginal compliance early,

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additional supervisory oversight may be employed to assure compliance management improvements are implemented and further deterioration of the institution's compliance performance is prevented.

Rating 4

An association in this category requires prompt supervisory intervention to correct serious compliance program deficiencies. Management has material shortfalls in its implementation of a comprehensive compliance management program as measured by SMAART. Management failures have resulted in substantive compliance violations, often involving a significant segment of consumers or requiring substantial monetary remedies, that have not been remedied on the institution's initiative in a timely fashion, or are significantly below standards for the institution's expected level of competence given its size, strategy, sophistication and risk profile. Close supervision of agency-directed institution self-assessment may be required to assure reliability or thoroughness of corrective actions. Transaction analysis supports the need for agency intervention to effectively supervise the institution's return to an acceptable level of compliance performance.

Rating 5

An association in this category is in need of the strongest supervisory intervention and oversight. SMAART components have been ineffectually implemented or ignored. The association is substantially in noncompliance with several of the civil rights, consumer or public interest statutes and regulations. The severity of its noncompliance creates legal and financial exposure of significant risk to the association. Management has demonstrated its unwillingness or inability to operate within the scope of these statutes and regulations. Previous efforts on the part of the regulatory authority to obtain voluntary compliance have not been effective. Discrimination, substantial overcharges or other practices resulting in systemic or serious repeat violations are present.