Introduction to Operations and Internal Controls

The operations area of the trust department is the focal point for all actions affecting trust and asset management accounts. All transactions initiated by the various areas of the department usually require some type of action by trust operations. Given the complexity and expense of the different trust operational systems, many trust departments now choose to outsource one or more of their operational functions. If such a choice is made, examiners should look for strong oversight and established internal controls.

The operations area has three major functions: 1) safekeeping and custody; 2) transaction processing and recordkeeping; and 3) regulatory compliance and reporting. The accounting system(s) required to handle these three broad areas of responsibility is extremely complex. It must be able to furnish detailed account information regarding the department's accounts to management, customers and regulatory agencies. The system of internal controls must ensure that records are accurate and assets are properly safeguarded. The system of processing assets, such as moving purchases or sales through the trading area or into or out of the vault, must also ensure that assets are properly safeguarded.

Operations and Internal Controls

"Operations" refers to the trust department's systems and procedures for implementing custody, collection, payment, reporting and processing. "Internal controls" refers to the systems and procedures, checks and balances, communication lines and warning signals, for safeguarding the customer assets under the control of the department through all the various phases of operations activity. Operations and internal controls are therefore closely related and must be evaluated together.

In evaluating the operations function, efficiency should be weighed against the adequacy and effectiveness of controls and safeguards. A highly efficient operation that is devoid of proper controls and safeguards poses a serious threat to the safeguarding of funds and securities and should be evaluated accordingly. Similarly, excessive or cumbersome controls may adversely impact the efficiency of operations, thereby affecting the quality of service to customers. Another consideration is that controls and audits tend to complement one another and weaknesses in one may be compensated for by strengths in the other. Despite the ideal of strict separation of the auditing and operations functions, internal auditors, particularly in smaller departments, may still perform duties such as reconcilements. In other savings associations these duties are performed exclusively by a separate operations or control unit. Thus, examiners should accept any arrangement as long as it is effective.

While operations and internal controls may vary widely from institution to institution based on the size and character of its trust and asset management business and the individual systems used, certain basic principles and controls should be in any system. Specifically, an effective system of operations and internal controls must ensure that:

- assets are adequately safeguarded;
- accounting data is accurate and reliable;
- timely information on accounts is available or can be provided;

- operating efficiency is maintained at an acceptable level;
- new financial products, services and future department growth are accommodated; and
- applicable law is followed.

The types of internal controls that are required depend upon the size and organization of the department. While it is not possible to outline specific control procedures, certain basic control devices should be found in varying degrees. These controls are discussed throughout this section. Examples of basic controls include separation of duties; accounting controls; controls over receipts and disbursements; dual control over assets; and asset and security movement controls.

Savings associations of all sizes must ensure that they maintain a strong control environment that influences the control consciousness of their personnel. This is the foundation of internal control and provides sound discipline and structure. Internal control environment factors include a well-defined organizational structure and workflow; proper audit coverage; defined integrity and ethical values; and sound written policies and procedures.

Larger departments should have a clearly defined organizational structure that provides the framework within which operations activities are planned, executed and monitored. Key areas of authority and responsibility should be established, as well as appropriate lines of reporting.

Books and Records

There are two statutory and regulatory requirements applicable to trust department books and records. First, HOLA requires a savings association to "keep a separate set of books and records" for its trust department (§5(n)(2)). That law is implemented by 12 CFR §550.430, which requires that a savings association "shall keep its fiduciary records separate and distinct from your other records." These requirements, coupled with the corollary requirement to segregate trust department assets from the savings association's own assets underpin one of the basic tenets of a trust and asset management relationship; these assets are not owned by the savings association and are not to be treated as assets of the savings association. Thus, if a savings association becomes insolvent, trust and asset management assets do not form part of the general assets of the savings association and are not subject to the claims of creditors.

The second statutory requirement that relates to trust department books and records is that records must show "in proper detail all transactions" or, as implemented by 12 CFR §550.410, the fiduciary "must keep adequate records for all fiduciary accounts." Adequate books and records are discussed in various contexts throughout the remainder of this chapter.

Separation of Duties

One of the basic principles of sound operations and internal controls is that of separation of duties and responsibilities. Simply put, this means that no one individual should be responsible for, or have complete control over, any transaction from beginning to end. Therefore, one individual should not be capable of authorizing, initiating and/or executing a transaction and then reviewing it for appropriateness. In a trust department, this concept begins by segregating administrative from operational functions and continues by segregating duties within the operating system itself. Adherence to this principal not only reduces the occurrence of unintended errors and mistakes but also reduces the opportunity for theft or embezzlement. For example, if one individual is responsible for all phases of check writing, the possibility exists that

through a combination of double or dummy entries and forgeries, the individual could obtain the proceeds of the check.

The extent that organizational functions and individual personnel duties are separated will depend primarily upon the size of the department. In larger departments, the volume of activity itself dictates the separation of duties. In other words, because of the amount of work, each employee typically performs only one task. In smaller departments, such a separation of duties may not be feasible since one person is usually required to do a number of tasks. Examiner judgment must be used in these instances to evaluate whether or not the department maintains an acceptable system of checks and balances. Size alone is not a valid reason for failing to implement at least minimal and basic internal control features.

Trust Accounting Principles

While accepted accounting principles apply generally to trust department recordkeeping, significant differences exist between the accounting systems used by the trust department and the savings association's other departments. Trust accounting does much more than just keep track of debits and credits. Trust accounting for example, must further distinguish debits and credits into income and principal. In addition, trust accounting involves keeping records of asset transactions, including the basis and market value of securities held by personal trust accounts. Another major difference is that the accounting for certain transactions may be mandated by either the governing document or by state law.

The most important detail regarding trust accounting is that each of the trust department's accounts must be treated as an individual entity. However, the accounting system adopted by the trust department must reflect not only a statement of condition for individual accounts but also aggregate statements for the department as a whole. Therefore, because the trust department does not account for its own assets but rather for the property of others, the "normal" accounting principal of assets minus liabilities equals capital, does not apply. Instead, a shorthand equivalent expression would be assets equal accountability (or liabilities). For trust accounting purposes, a trust department's assets consist of all the property being held in individual accounts. Similarly, its liabilities consist of the carrying value of all the individual accounts. Stated another way, a department's assets, its securities, deposits, real property, etc. held by it for others, are also its liabilities, since the department is accountable (liable) to others for those assets.

Accounting control is achieved by balancing individual account ledgers against the trust department's general ledger. Certain activity relating to the trust department should also be included in the savings association's general ledger and financial statements. For example, cash balances in individual accounts, which are deposited with the savings association in demand and time deposit accounts, revenues and expenses of the trust department may be recorded on its general ledger.

Accounting Systems and Records

In order to effectively administer its trust accounts, trust operations in general must provide comprehensive and detailed recordkeeping and information systems. Accounting systems within a trust department may range from hand-posted records to sophisticated electronic data processing systems. Such systems may be developed within a trust operations department or utilized on an outsourced basis. According to the AICPA's Industry Audit Guide, the accounting records of a trust department should, at least, reflect the asset holdings and liabilities of each customer, the status of each trust account and all transactions relating to each account. This requires records relating to the trust department's total asset holdings and total liability, which will be in its general ledger. It also requires records that can provide detailed information for each trust

account, including: income; principal; transactions related to investments; and lists of assets held by amount and type. The information for each of these categories will most likely be in a separate control account. The values at which assets of the various trust accounts are carried on the ledger may vary. These values may include: nominal value ($1 for control purposes); cost or basis (for tax purposes); or market value.

As mentioned above, the sophistication of the trust department as well as the accounting systems utilized will vary in relation to the size and character of accounts administered. However, the recordkeeping concepts and principles involved remain the same: trust records must be maintained so as to clearly reflect the interests of the various accounts and to permit a thorough and satisfactory examination.

The following information typically appears in trust department records, as applicable, for each asset held by the trust department:

- CUSIP or property number
- Asset description
- Asset type
- Basis (or cost) for tax purposes
- Market price
- Interest rate and maturity date

Trust department records should generally consist of the following:

- ***General ledger***. The general ledger will comprise all control accounts of the department. It includes both customer as well as internal accounts used by the department to facilitate its operation. Many automated systems have subsidiary control records but do not have the traditional "general ledger."
- ***Asset control accounts***. These accounts should reflect total holdings of major asset categories, such as stocks, bonds or deposits.
- ***Subsidiary asset controls***. These accounts will reflect total investments in specific issues of stocks, bonds, etc.
- ***Liability control accounts***. These accounts will reflect the total of cash and investment holdings of each type of account administered. This category should be further subclassified to allow the department to post transactions to individual accounts. The cash ledger should detail income and principal cash and reflect transactions in chronological sequence. The investment ledger should reflect each asset held by a trust account. Purchase, sales, stock dividends and splits should be recorded in chronological order.
- ***Journals, ledgers, files and other records of original entry***. While these records may also be maintained in a variety of forms, they should all furnish the figures which are to be posted to the general ledger or control accounts, provide the basis for the entries which may be made on all other records affected by each transaction and provide a chronological record of all the day's transactions. In a nonautomated system, these records would normally include a blotter and a transaction journal. From these sources, posting is done to individual ledgers, which should in turn be balanced periodically to the general ledger. In an automated system, internal balancing control procedures

should be performed each time the ledgers are posted. These procedures should include the balancing of totals on the transaction journal and verification that ledger records balance to the general ledger.

- ***Individual Account Records***. These records should be maintained for each individual account administered by the department and should reflect transaction histories, list individual assets and provide a total of individual investments and cash for each account.
- ***Other Records***. Other records which affect the operation of a department to a significant degree and which an examiner will find useful in the examination process are a securities transaction register, a vault control log and broker statements. The securities transaction register is a record of all securities transactions listed in chronological order. A vault control log is used to record the dates and identities of individuals who accessed the department's vault. Records should also be maintained indicating which vault contents were accessed and the reasons for the access. Broker statements are similar in some respects to deposit account statements, they reflect all trust department securities transactions. These statements should be reviewed carefully by the department and reconciled to broker confirmations and the bank's securities transaction register.

In addition, there are several other subsidiary accounting records, which should be maintained in all trust departments. They include a digest or synopsis record (which highlights important provisions of the governing instrument such as remittance instructions), a tickler system (which is a chronologically arranged system of records to remind the department of routine and recurring tasks, such as collecting income, distributing funds and calculating fees), security ledgers (which lists securities by issue rather than by individual account), dividend and other claim records (which includes receivables and payables), cash management accounts (which reflect daily cash transactions and balancing) and suspense accounts (which are used to hold transactions for a short time when uncertainty exists as to the correct trust account posting of an income item).

In order to ensure the accuracy and reliability of the department's accounting system, it must be reconciled and controlled on a routine and timely basis. Generally accepted trust department practices normally call for daily posting of account records and ledgers and for, at least, monthly balancing and reconcilements of records and ledgers in a nonautomated department. However, individual circumstances such as the level and type of activity may justify a different timeframe. In most automated systems, ledger controls are internally maintained as part of the system's verification procedures. These procedures normally provide for the automatic, daily balancing of separate asset and liability files. If any discrepancies arise as a result of such balancing, the savings association should begin to promptly research and/or correct.

Principal and Income

A fundamental and significant principle in trust accounting as opposed to other types of accounting is the requirement that separate records must normally be maintained to distinguish between the principal and income of a trust, including principal and income cash. The trust accounting system must ensure that principal and income flow to the intended class of beneficiary. For example, a trust may provide that one or more individuals, referred to as income beneficiaries, are entitled to receive current income of the trust; while other individuals, referred to as remainder beneficiaries or remaindermen, are entitled to the trust property after expiration of the income interest or death of the income beneficiary. However, this distinction is not important for employee benefit trusts as plan participants are entitled to all the benefits of the plan.

The principal (or corpus) of the trust is defined as cash and other property transferred to the trust and any appreciation derived from holding such property. Income is defined as the return derived from the use of

principal, such as (in most cases) dividends, interest, rents or royalties. Income may be distributed as cash or reinvested for the account and held as invested income. The trust agreement often provides specific guidance for allocation of principal and income, usually to the different beneficiaries or to the trust itself. Additional guidance is provided under the applicable state's principal and income act that is based in large part on the Uniform Principal and Income Act. Examiners are reminded that states many times modify "uniform" acts during the legislative process. Consequently, the law of any state may depart in small or large measure from the "uniform" act. To add to the confusion, there are several uniform acts in existence, as it has been amended several times, therefore states have enacted variations of different uniform acts.

Outsourcing Arrangements

Many trust departments find it is financially beneficial to outsource some or all trust accounting functions to third parties or affiliates. Outsourcing of trust operations does not relieve management of its responsibilities to provide oversight and control risks. Outsourcing arrangements present four key challenges, which, if not addressed adequately, introduce significant risks for the financial institution. The primary challenges are:

- ***Selecting a qualified vendor and structuring the outsourcing arrangement***. The failure to choose a qualified and compatible service provider through an appropriate due diligence process and structure an adequate outsourcing relationship, may lead to ongoing operational problems or even a severe business disruption. The contract should clearly articulate the structure of the outsourcing arrangement and the expectations of both sides, including renewal and termination terms; otherwise, excessive amounts of management time may be consumed with dispute resolution or with managing a contentious relationship.
- ***Managing and monitoring the outsourcing arrangement***. Without active management and monitoring of the relationship, subpar service may occur or, at the extreme, loss of control over the outsourced activity. Even when alternatives are available, switching service providers is likely to be a costly option that adds to operational, legal and reputation risks. The outsourcing contract and internal risk management should ensure that complete and immediate access to critical information is available.
- ***Ensuring effective controls and independent validation***. Given the reliance on a third party for the performance of critical activities, there is a risk that without independent validation of the control environment the savings association cannot determine that the controls have been effectively implemented. A savings association's internal audit function or evaluation by a third-party reviewer can accomplish this. The right of independent validation should be established in the contract.
- ***Ensuring viable contingency planning***. Given the dependency on a third-party service provider, savings associations face the challenge of ensuring adequate contingency planning to avoid business disruptions. Management should verify that the service provider has an adequate contingency plan. Furthermore, savings associations need their own contingency plan in the event of nonperformance by their service provider. The failure to provide for an adequate contingency plan by both the service provider and the savings association may result in unintended financial losses, missed business opportunities and reputation damage.

While a third party provider may be performing the actual functions, it is merely acting as an agent of the trustee and the trustee can still be liable for any mistakes or errors made by its agent. Therefore, if a trust department decides to outsource any operational functions, it must establish a monitoring system for these outsourced functions. The following is a list of items that may require management action or monitoring in an outsourced environment:

- New account information
- Name and address changes
- Fee schedules
- Tickler records
- Initial write up of transactions
- Review of all account data after posting
- Control totals
- Demand deposit account reconciliation
- Daily wire settlement
- Overdraft and excess cash balances
- Affirmation of trades
- Communication on corporate actions
- Income collection for unique assets
- Provide information for nonrecurring checks
- Mail customer reports

Safekeeping and Custody of Assets

Introduction

The operations area is responsible for safeguarding trust assets from the time that they are received until the time those assets are sold, transferred or otherwise delivered out of the trust department. This section discusses procedures and controls that a trust department utilizes to protect its customers' assets.

Section 5(n)(2) of HOLA requires a savings association to "segregate all assets held in any fiduciary capacity from the general assets of the institution". That requirement is implemented by 12 CFR §550.250, which requires the investments of each account to be kept separate from the assets of the savings association and from all other accounts (except when invested in common or collective investment funds). To satisfy this and other safeguarding requirements, basic internal controls that should be present in all departments include:

- ***Dual Control***. As required by 12 CFR §550.230, access to fiduciary account assets should be authorized by at least two designated individuals (defined as officers or employees designated for that purpose either by the board of directors or by a person(s) designated by them). Written procedures should be in place to ensure that dual control procedures are followed in transactions of fiduciary account assets.
- ***Vault Access***. Access to the location where assets are stored should be restricted to authorized personnel. Assets are normally stored in either a separate trust vault or in a separate area of the savings association's main vault. Individuals that access the vault should sign vault logs or other control

records and individuals that control the vault should verify that such personnel are authorized to enter the vault.

- ***Separation of Duties***. A basic concept of internal controls is that control can best be achieved through a separation of duties. No individual should therefore be permitted to both execute and review any transaction. For example, individuals assigned responsibility to execute securities transactions should not be authorized to reconcile daily securities transactions.
- ***Physical Vault Protection Measures***. The vault used for the safekeeping of trust department assets should provide for minimum security devices consistent with the requirements of the Bank Protection Act and related OTS regulations, which provide for (among other things) the installation of appropriate lighting, alarm and other physical security controls. Further information concerning protective measures can be found in the OTS Compliance Activities Handbook, Section 405, Bank Protection Act.
- ***Reconcilements***. Individuals who initiate or authorize transactions or routinely post to the recordkeeping system should not perform reconcilements of deposit accounts, suspense accounts and securities depository statements. In addition, exceptions should be documented and followed up until resolved.
- ***Tickler Systems***. Accurate and timely processing of operational items requires operation personnel's timely attention to nonroutine and nonrecurring tasks. The administration of numerous accounts, each having its own unique servicing requirements, necessitates adoption of a uniform system of control to ensure the timely and accurate performance of these duties. Many institutions implement a tickler system to monitor these activities. A tickler system is nothing more than a chronologically arranged system of records that reminds department employees to collect income, distribute funds and calculate trust fees, etc. Though simple in design and concept, accuracy and effective use of its contents can be critical for account administration.
- ***Other Control Elements***. The organizational structure of a trust department is another component of overall control. Management must define its functional lines of responsibility and establish an organizational framework along those lines. It must then develop logical patterns of workflow. These procedures should take into account the need for checks and balances as well as the need for an efficient, practical system. Control systems should be reviewed regularly and continuously updated. Review of organizational and system controls should be incorporated into the savings association's risk management assessment process. Although they will vary from institution to institution, each control system should encompass the following in some form:

  - Adoption of a comprehensive operations manual
  - Provision for surprise audits (internal and external)
  - Periodic verification of assets held at the institution
  - Daily proof of transactions (balancing and closing routines)
  - Review and signing of transaction journals by administrators
  - Maintenance of accounting records on a current basis
  - Requirements for regular, separate account reconciliation
  - Dual signature requirements for checks over a certain dollar amount

- Requirements for documentation authorizing asset changes, cash distributions and large overdrafts
- Use of prenumbered documents in sequential order
- Audit trails for all accounting transactions
- Proof of records by individuals not authorized to post them
- Review of accounts by individuals other than the administrator assigned to them
- Separate control over checks returned undelivered
- Procedures for reissuance of returned checks
- Adequate record retention policy
- Separated responsibilities for customer statement review and processing

Examiners should recognize that an effective system of policies and procedures designed to establish dual control, duty separation and rotation may be costly. Examiners need to exercise judgment in assessing a department's control system. For example, a system may have one or more deficiencies but the system may be strengthened by reliance upon a strong audit or compliance/quality control review function.

Nominee Registration

Nominee ownership is a means of registering securities in the name of a person, partnership or corporation. Nominee ownership is used to facilitate the management of trust department accounts. When many accounts in a trust department hold shares in the same company, for example, the nominee method makes it easier to sell or transfer securities and to collect interest and dividends. When a securities issuer pays interest or declares a dividend, the institution receives a single dividend or interest payment in the nominee name in which the security is registered. The department then credits the proper accounts holding the particular security, typically using an automated report called a "dividend map." Without the use of nominee registration, separate dividend or interest payments would be received for each account holding the security.

Nearly all states provide by statute that trust department securities may be registered in nominee form and most governing instruments also authorize the department to do so. For the trust department to utilize nominee registration, the board of directors must authorize the execution of a partnership agreement between designated personnel and the institution. This agreement establishes a legal name, which should be registered with the state. Securities held in the trust department can then be registered in the name of that nominee. Examiners should ascertain that the department's nominee partnership agreements are periodically reviewed to ensure that they are current. For example, an examiner should determine whether all of the partners are still with the trust department.

As a rule, the institution should not register securities in the street name of a broker-dealer. An exception to this prohibition may be when the trust department is acting as an agent for investment management services. However, the institution should ensure that any arrangement with a broker-dealer adequately indemnifies the institution from risk of loss or manipulation by the broker.

Securities Lending

Some trust departments are involved in securities lending activities. This is a fee-based service whereby the trust department lends customers' securities held in certain trust department accounts; common and collective investment funds; as well as proprietary mutual funds.

Securities lending primarily occurs in employee benefit plans maintained by large employers. Personal trust accounts and agency accounts are involved to a lesser degree. The primary borrowers of securities are brokers and commercial banks. The securities are borrowed to cover securities fails (securities sold but not delivered), short sales and for option and arbitrage positions. Securities lending is conducted through open-ended agreements that may be terminated on short notice by either the lender or borrower. The objective of such lending is to increase a portfolio's yield beyond the collection of interest and/or dividends.

Securities lending occurring in qualified employee benefit accounts are subject to the Employee Retirement Income Security Act of 1974 (ERISA). Securities lending transactions between a plan and a party in interest would ordinarily be prohibited by ERISA, however, a prohibited transaction class exemption has been issued by the Department of Labor (PTE 81-6) which permits a party in interest to lend securities of employee benefit plans to which it provides services. The exemption contains specific requirements regarding type and amount of collateral, documentation, terms of the loan, compensation and termination of the arrangement.

Some of the restrictions contained in PTE 81-6 are as follows:

- The borrower (or its affiliate) may not have any investment discretion over the plan assets involved in the transaction or render investment advice to the plan.
- The plan receives from the borrower, by the close of the business day on which the securities are delivered to the borrower, collateral consisting of cash, securities issued or guaranteed by the U.S. government or its agencies, or irrevocable bank letters of credit issued by a person other than the borrower (or its affiliate), equal to 100 percent of the market value of the securities lent. Collateral value and market value are to be determined as of the close of business on the preceding business day.
- Prior to any securities lending transaction, the borrower furnishes to the lending entity the most recently available audited statement of the borrower's financial condition (or an unaudited statement if it is more recent) and a representation that, at the time the securities lending transaction is negotiated, that there has been no material adverse change in its financial condition since the date of the most recent financial statement.
- The securities lending transaction is made pursuant to a written agreement the terms of which are at least as favorable to the plan as an arms length transaction with an unrelated party.
- The plan (1) receives a reasonable fee that is related to the value of the borrowed securities and the duration of the transaction or (2) has the opportunity to derive compensation through the investment of the cash collateral.
- The plan receives the equivalent of all distributions made to holders of the borrowed securities during the term of the loan, including, but not limited to cash dividends, interest payments, shares of stock as a result of stock splits and rights to purchase additional securities.
- The market value of the collateral held by the plan must be maintained at 100% of the market value of the securities out on loan.

- The transaction may be terminated by the plan at any time.

Another prohibited transaction class exemption related to securities lending activities of employee benefit plan assets is PTE 82-63. This exemption provides relief from the prohibitions of ERISA Section 406(b)(1) for certain compensation arrangements and also authorizes common and/or collective investment funds in which employee benefit assets are invested, to engage in securities lending transactions. The exemption does not dictate a specific form of compensation but instead merely indicates that the compensation received by the lending fiduciary (i.e. the savings association) must be reasonable and paid in accordance with the terms of a written agreement. Another condition is that the securities lending arrangement must be approved in writing by a plan fiduciary that is independent of the lending fiduciary. The independent plan fiduciary must be able to terminate the arrangement within prescribed time periods without penalty to the plan. The lending fiduciary must also provide the independent plan fiduciary with all reasonably available and necessary information regarding the securities lending arrangement.

For those accounts not governed by ERISA, securities lending activities should be conducted by knowledgeable management, in accordance with written policies and procedures under an adequate system of monitoring and controls. At a minimum, policies and procedures should cover each of the following (See Revised Federal Financial Institutions Examination Council Supervisory Policy, July 21, 1997):

- ***Recordkeeping.*** A recordkeeping system should produce daily reports showing which securities are available for lending; which are currently lent; outstanding loans by borrower; outstanding loans by account; new loans; returns of loaned securities; and transactions by account. These records should be updated as often as necessary to ensure that the lender institution fully accounts for all outstanding loans; that adequate collateral is required and maintained; and that policies and concentration limits are being followed.
- ***Administrative Procedures.*** All securities lent and all securities standing as collateral must be marked to market daily. Procedures must ensure that any necessary calls for additional margin are made on a timely basis. In addition, written procedures should outline how to choose the trust department account that will be the source of lent securities when they are held in more than one account. Security loans should be fairly allocated among all accounts participating in a securities lending program. Internal controls should include operating procedures designed to segregate duties and timely management reporting systems. Periodic internal audits should assess the accuracy of accounting records; the timeliness of management reports; and the lender institution's overall compliance with established policies and procedures.
- ***Credit Analysis and Approval of Borrowers.*** Credit and limit approvals should be based upon a credit analysis of the borrower. Such an analysis should be performed prior to establishing a lending relationship and periodically thereafter. Credit reviews should include an analysis of the borrower's financial statement and any other factors that appear relevant.
- ***Credit and Concentration Limits.*** An individual credit limit should be established for each borrower. That limit should be based on the market value of the securities to be borrowed and should take into account possible temporary (overnight) exposures resulting from a decline in collateral values or from occasional inadvertent delays in transferring collateral.
- ***Collateral Management.*** Security borrowers must pledge and maintain collateral that is at least 100% of the value of the securities borrowed. Excess collateral should be required in cases of volatility of the loaned securities or the nature of the collateral, if other than cash. Generally, the minimum initial

collateral on security loans is at least 102% of the market value of the lent securities, plus, for debt securities, any accrued interest. A daily "mark-to-market" procedure must be in place to ensure that calls for additional collateral are made on a timely basis. Securities should not be lent unless collateral has been received or will be received simultaneously with the loan.

- ***Cash as Collateral.*** When cash is used as collateral, the savings association as lender is responsible for making it income productive. Generally, a savings association will invest cash collateral in repurchase agreements, master notes, a short-term investment fund, U.S. or Eurodollar certificates of deposits, commercial paper or some other type of money market instrument. The written agreement authorizing the lending relationship should specify how cash collateral is to be invested. NOTE: If the cash collateral is invested in a mutual fund, common or collective fund or other pooled fund maintained by the savings association or its affiliate or where the savings association or its affiliate acts as investment adviser, there is a conflict of interest which can be overcome only by specific language in the securities lending agreement or other governing document, state or federal law or court order.
- ***Letters of Credit as Collateral.*** Since May 1982, letters of credit have been permitted as collateral in certain securities lending transactions outlined in Federal Reserve Regulation T. If a lender institution plans to accept letters of credit as collateral, it should establish guidelines for their use. Those guidelines should require a credit analysis of the financial institution issuing the letter of credit before securities are lent against that collateral. Analyses must be periodically updated and reevaluated.
- ***Written Agreements.*** Securities should only be lent pursuant to a written agreement between the savings association as lender and the owner of the securities (generally the plan sponsor) specifically authorizing the savings association to offer the securities for loan. The agreement should outline the savings association's authority to reinvest cash collateral (if any) and its responsibilities with regard to custody and valuation of the collateral. In addition, the agreement should detail the fee or compensation that will go to the savings association in the form of a fee schedule or other specific provision. The savings association as lender must also have written agreements with the parties who wish to borrow securities. These agreements should specify the duties and responsibilities of each party.

Trust departments must also take the following into consideration before engaging in any securities lending transactions:

- Authorization by the governing account instrument or appropriate state law.
- For accounts over which the bank exercises investment discretion, the decision to lend securities represents an investment decision, which should meet the appropriate fiduciary standards. The following considerations should be documented: 1) the appropriateness of the transaction with regards to account objectives and beneficiary needs; 2) diversification; and 3) the prudence of the investment.

Off-Premises Custody

12 CFR §550.240 permits investments of a fiduciary account to be deposited elsewhere to the extent permitted by law. The laws of most states do in fact permit such deposits. Savings associations have increasingly chosen to hold trust department assets in an off-premises depository, such as a national or regional securities depository (for stocks and bonds), a Federal Reserve Bank (for book-entry holding of U.S. Government obligations) or a correspondent institution. For assets held at a depository (or other location), the trust department should ensure that the depository has established adequate controls and safeguards and

that it provides adequate insurance coverage against possible loss or theft. ERISA, in §404(b) contains very strict guidelines regarding the maintenance of the indicia of ownership of any plan asset outside the jurisdiction of the district court of the United States. Regulations issued by the Department of Labor at 29 CFR §2550.404(B-1) do provide some exceptions.

When assets are deposited elsewhere, the trust department should ensure that its own recordkeeping system does the following:

- Records the actual location of each asset
- Reconciles changes in the depository position daily and fully reconciles its position at least monthly
- Provides dual control procedures for the release of securities from the depository
- Ensures that any release of securities directed via telephone, fax or e-mail is properly confirmed
- Ensures that terminal interfaces used to effect withdrawals are subject to appropriate password access controls

Deficiencies in Operations and Controls

Losses and unwarranted exposure due to misappropriation, fraud or embezzlement has in many cases occurred when deficiencies existed in operations or controls. While discovery of such defalcations is not the primary objective of a trust and asset management examination, the examiner should nevertheless be alert to practices that could permit or encourage them.

The following is a partial list of the areas in a trust department that are particularly susceptible to manipulation and abuse. These are merely to be used as examples and are not meant to be an all-inclusive list of the weaknesses that may occur within a savings association's trust operations area. Examiners and trust department management may want to refer to these examples as tools when assessing the controls existing within a savings association's trust operations function. However, management's most effective means of preventing defalcations is a system of comprehensive internal controls and a good audit program.

- ***Failure to record the receipt of assets when accounts are opened***. Detection of a theft is nearly impossible if an asset has never been recorded on the institution's ledgers. The unwitnessed assembling of assets, particularly those of decedents' estates, is a dangerous practice. In such cases, detection of theft may be impossible since no record of a missing asset exists in the savings association's files.
- ***Unauthorized or forged withdrawals of cash and securities from accounts***. Typically caused by the absence of dual controls, this practice involves the manipulator transferring assets to his or her own control, where the assets are then sold, pledged for personal loans or used in market speculation.
- ***Diversion of income on assets received in either irregular amounts or at irregular intervals***. Most often involves diverting income on assets received in either irregular amounts or at irregular intervals (thus making it less likely to detect) out of the trust department's account and into the employee's personal account. Such income is usually derived from royalties, oil wells and the like. Income from all investments should be internally controlled and audited, with added attention given those situations where investments produce income irregularly.

- ***Diversion of stale outstanding checks, inactive deposits and assets of dormant accounts for personal gain***. A combination of independent and timely reconcilement procedures, together with the periodic tracing of transactions from initiation to conclusion can greatly reduce the likelihood of such diversions.
- ***Falsification of expenses and misapplication of commissions and fees***. Expenses and recurring fees present possibilities for manipulation. The savings association should have a policy that requires expenses to be accompanied by appropriate documentation. Individual account administrators should not have control or access to expense checks. Similarly, adequate internal safeguards should exist to assure the crediting of commissions and fees to the appropriate accounts.
- ***Manipulation of payments received on rental properties, real estate and real estate mortgages***. Administration of these trust and asset management account properties frequently involves handling cash payments received in the trust department in person or through the mails. Unless strong internal controls are in effect, defalcations through manipulation of payments could occur.
- ***Improper use of suspense accounts***. Frequently, trust department suspense accounts are not governed by good internal control procedures and unauthorized settlements or disbursements may easily occur.
- ***Misuse of corporate bonds, notes and stock certificates***. Usually occurs where the trust department is holding inventories of unissued securities not under dual control. Securities are stolen, sold or used as collateral for loans.

Improper or illegal securities trading practices

- Placing personal trades through institution accounts, thereby obtaining the advantage of the savings association's volume discounts on commissions;
- Purchasing or selling an issue of securities prior to executing trust and asset management account trades which could be expected to change the price of the security, thereby obtaining a personal price advantage ("front-running");
- Purchasing and selling the same securities issue on the same day, with the trader pocketing any price increases and assigning transactions to trust and asset management accounts in the event of any price decreases; and
- Buying or selling based on nonpublic material inside information that might affect the price of the securities, thereby enabling the trader to benefit personally from the transaction. This is a violation of securities laws that should be reported to the Securities and Exchange Commission (SEC).

Securities Processing Systems and Controls

The operations area is responsible for the processing of securities and other assets. (For convenience, the term "securities" is used in this section to refer to trust department assets). Securities processing includes both the physical movement of securities through the department (i.e., from the vault through the processing or trading area, through settlement and out of the department) and the controls in effect over that movement. Specifically, the securities processing area is responsible for securities trading and settlement activities involving:

- receipt of authorization and instruction for a securities trade (purchase or sale);
- placement of the trade with a broker or trading desk for execution;
- reconcilement of in-house trade information to broker's confirmation received subsequent to trade execution;
- receipt or delivery of securities against payment; and
- posting of the trade to the affected account.

Any operations function, regardless of the department's size, must devise a system for monitoring and controlling the movement of securities and the processing of daily and periodic transactions and withdrawals. Many institutions have designed and implemented formal security movement and control systems. The objective of such systems, commonly referred to as "SMAC" systems, is to detail all asset movements. A manual SMAC system utilizes manually prepared security tickets for the purpose of monitoring and controlling security movement activities. Automated SMAC systems improve the control over and monitoring of security activities through system-generated management and/or exception reports that are available daily or on demand. One of the principal benefits of an automated SMAC system is its ability to reference, extract and post to an automated recordkeeping system. Therefore, such systems are either incorporated within an automated recordkeeping system or are designed as independent systems with the capability (system interface) of accomplishing these benefits.

Regardless of the formality with which such systems are utilized in a particular department, the control aspects of these systems should include:

- written acknowledgment by joint custodians;
- date of all vault transactions;
- description of securities;
- identity of the affected account; and
- information regarding the transaction, including, for example, the source of the securities being deposited and the purpose for which securities are being withdrawn.

Trade Orders and Executions

Purchase or sale orders for accounts can, depending on the savings association's investment responsibility, be initiated from the trust department's authorized investment personnel, from customers or from outside investment advisors or managers. When received, such orders should be documented on order tickets or similar records and should include the account for which the order is to be executed; a full description of the security; the time the order was received by the trader; the time the order was placed with the broker; the unit and aggregate price at which the order was executed; the broker utilized; and whether or not the transaction is subject to any special instructions. Those records should be maintained in a manner that provides a chronological record of all daily activity. In the past, many departments utilized prenumbered multi-part forms that monitor an individual trade from beginning to end. However, this process is increasingly giving way to electronic tracking of trade orders.

One of the fundamental duties of a fiduciary is to seek the best execution for its customers when trading securities. While this is not strictly an operations function, the operations area can nevertheless provide input into this determination by providing information as to the timeliness and accuracy of trade execution and settlement services provided by the broker, any commission discounts given and the broker's ability to handle block trades.

Confirmation, Settlement and Posting

Brokers are required to provide written confirmation to the department following notification of execution. The confirmation should include the full details of the trade and be reconciled to the original trade memoranda by a person independent of the person who placed the trade. Similarly, the department should send a copy of the confirmation to the customer, detailing the transaction and including any fees charged to the account. Generally accepted fiduciary principles, SEC rules as well as those of the other bank regulatory agencies (12 CFR Part 12) provide certain confirmation requirements. For example, the time, form and content of the confirmation or notification is prescribed as well as the circumstances under which a customer can waive his or her right to receive the confirmation.

Settlement occurs when securities are exchanged for cash payment. The date of settlement is generally set at three business days after execution of the trade (T + 3) but may vary by agreement between the institution and the broker or the type of security being traded. Any position that remains open past settlement date should be subject to written procedures.

Securities trades are posted in one of two ways. Under the first, referred to as contractual settlement date accounting, the customer's account is posted on the contractual settlement date specified on the trade confirmation, regardless of whether or not the security is actually received. An offsetting entry for payment is made to a separate suspense account for purchases and sales. That entry is cleared when the securities are actually received and payment is made. Under the second, referred to as actual settlement date accounting, the customer's account is posted on the actual date of settlement. Most automated accounting systems enter pending trade notifications to customers' accounts when trades are executed and do not make offsetting cash entries until actual settlement occurs. These systems also monitor open trades by producing daily reports listing trades open past settlement date.

Receipts and Disbursements

The securities processing unit is responsible for the collection of receipts payable on trust department assets such as dividends, interest, rents, royalties and other cash and noncash payments. Income may be received on either a regular basis, such as bond interest, or an irregular basis, such as royalties on mineral interests. In either case the department should have a tickler or similar system to monitor the receipt of all income to ensure that it is received when due. Such tickler systems can range from a card index that details fixed income payments and serves as a reminder on irregular ones (found in smaller, nonautomated departments) to a system-generated report of anticipated income (found in automated departments). An automated system will usually credit the appropriate accounts with the income due, once the payment is received.

Over or underpayments of income should be posted to a suspense account or otherwise earmarked as due, pending further research. Funds received as overpayments should be held pending a documented claim from the rightful owner. In the absence of a claim and if a certain amount of time passes (usually seven years, but state law should be consulted), the department is required to comply with state laws regarding escheatable or unclaimed funds. In the case of pension assets subject to ERISA, the examiner should note that the

Department of Labor has taken the position in many advisory opinion letters that pension plan assets may never be escheated to a state.

When the department has not received full payment, established procedures should be followed to determine the reason for the underpayment and a written claim against the appropriate party should be filed.

All requests for disbursements, whether for cash, securities or other assets, should follow established procedures. While the form and content of acceptable procedures may vary, they should at least provide that disbursements will be made only upon written request to authorized personnel and that receipts should be obtained.

Miscellaneous Trust Department Operational Activities

Introduction

An additional function of trust operations and sound internal controls is to ensure compliance with management policies, applicable law and established fiduciary principles. While the previous sections focused on systems and procedures as they relate to overall trust department operations, this section focuses on the role that trust operations plays in ensuring compliance when the trust department engages in certain activities.

Cash Management - Uninvested Cash

Trust and asset management accounts often receive cash in the form of receipts (dividend and interest payments) or contributions. These accounts may need cash in order to make required distributions and to pay expenses. Thus, it is rare that an account will have all of its assets invested all of the time. On the other hand, 12 CFR §550.290 requires that fiduciary funds, where the savings association has investment discretion or discretion over distributions, that are awaiting investment or distribution, are not to be held uninvested or undistributed any longer than is reasonable for the proper management of the account. Section §550.300 provides that any funds awaiting investment or distribution may be deposited in other departments of the savings association, unless prohibited by applicable law. Both sections require that fiduciary funds so invested must obtain a rate of return that is consistent with applicable law. These regulations essentially codify the common law responsibility to make trust property productive. Fiduciaries have been held liable for failing to invest cash within an appropriate period of time. In these circumstances the fiduciary has been surcharged for the earnings that could have been obtained had the funds been properly invested.

In order to satisfy the standard set forth in §550.290 and to demonstrate compliance with a fiduciary's common law duty to make trust property productive, a trust department should have an effective and efficient cash management system. Such a system should:

- minimize the dollar amount and length of time that income and principal cash is left uninvested in an account; and
- place available cash, on a daily basis, into short-term vehicles that return a reasonable rate of interest.

The application of these regulations must necessarily be based upon a review of all the facts and circumstances relevant to each savings association and to each affected account. However, to ensure

compliance and to avoid possible surcharge, the department should have written policies and procedures to govern the management of cash in fiduciary accounts and should utilize cash management systems and techniques. The decision to leave any cash uninvested in fiduciary accounts should be supported and documented in the trust department's records.

A cash management vehicle should be able to provide a high degree of liquidity and safety. Examples include short-term time deposits; U.S. Treasury bills; commercial paper; money market funds; short-term investment funds; deposit accounts; and corporate variable amount or master notes. The investment vehicle used for cash management purposes must be prudently selected and any conflict of interest overcome by appropriate state law, document language or court order.

Some savings associations have historically placed uninvested funds in a savings account. However, given the number of alternative cash management vehicles available in the current financial environment, it would be exceedingly difficult to justify holding a large cash balance in a savings account. Similarly, some savings associations historically utilized a zero interest time deposit open account (TDOA) for trust account cash. According to the Federal Reserve Board, (in a letter dated May 17, 1991 to the OCC) it was general practice not to pay interest on these accounts. For the reasons noted above, generally restated in the Fed's letter, this practice should be viewed as inconsistent with basic fiduciary responsibilities and sound trust department administration.

Cash Sweep Fees

Savings associations are increasingly utilizing automated accounting systems to provide cash management programs. Under these "cash sweep" systems, uninvested cash and/or available cash balances are automatically swept into one or more short-term vehicles of the type described above. In a nonautomated department, acceptable and effective cash management practices may consist of placing the funds in a money market deposit account or mutual fund.

A department's cash sweep service for fiduciary accounts where the savings association has investment discretion may raise questions in addition to those discussed above if a separate fee is involved, either directly or indirectly. The practice of sweeping fiduciary account cash and receiving a separate fee for this service has been the subject of litigation in various courts. The separate fee issue has not been decided, as of yet, by any U.S. Appellate courts. The one case that had reached that level was dismissed on jurisdictional grounds. As a result, the question of whether a fiduciary may charge an additional or extra fee for its cash sweep service depends upon the law in a particular state or the specific language in the governing document. The following guidelines may be applied to discretionary fiduciary accounts where a separate fee is charged in connection with cash sweep services:

- An initial determination should be made as to whether the fee is specifically permitted by state law or permitted under the terms of the governing instrument.
- If state law specifically permits the fee, then no further inquiry need be made except in terms of determining compliance with any of the statutory restrictions. The same reasoning applies in connection with authorization language in the governing document.
- If state law or the governing instrument does not specifically permit the fee, the institution should obtain a reasoned opinion of counsel that addresses the permissibility of the fee, including any requirements relating to authorization, consent and/or disclosure.

- If state law permits "reasonable" fees, the department should consider the extent to which such a sweep fee may be charged as well as what authorizations, consents, and/or disclosures should be obtained or provided.
- If the fiduciary's compensation is fixed by statute or in the governing instrument, then all parties affected by a change must consent to the change. An opinion of counsel should be obtained to ascertain how consent may be obtained for minor beneficiaries, unknown or unborn beneficiaries.
- Imposition of a sweep fee for accounts in which a savings association has investment discretion may also raise conflict of interest questions, depending on the investment vehicle utilized in the sweep arrangement. If the investment vehicle is a proprietary mutual fund or a mutual fund in which the savings association receives direct or indirect compensation, a specific state statute, language in the governing instrument or a court order must be in place permitting the use of the mutual fund.
- With respect to this practice for employee benefit accounts subject to ERISA, a department should be encouraged to seek the prior advice of the Department of Labor or have a reasoned opinion of counsel that considers the sweep service in relation to ERISA's prohibited transaction provisions. The DOL has indicated in Advisory Opinion 88-02A (February 2, 1988) that such sweep services will not violate 406(a), 406(b)(1)(2) or (3) of ERISA provided that the institution does not have investment discretion over the plan assets and that an independent investment advisor determines whether and how much uninvested cash will be swept and chooses which of several money market funds will be utilized. An independent third party sponsored all of the funds in question. Another condition is that the bank, in this case, did not receive a fee or other compensation for any of the money market funds involved in the sweep program. Another condition that the DOL notes is that the plan must be notified no less than 30 days prior to any change in the fees to be charged for the service and that the arrangement is subject to immediate termination without penalty.

Revocable trust accounts where the savings association does not have full investment discretion and custodial trust accounts may be charged a separate fee for sweeping services provided appropriate disclosure is made and there are no prohibitions in either state law or in the governing instrument.

Overdrafts

Overdrafts occur when more income or principal cash is disbursed than exists in a particular account. Overdrafts can result from problems that arise due to differences in settlement cycles, cash distributions that must be made in accordance with the governing instrument without sufficient liquid assets in the account or from other causes. Overdrafts in general should be temporary in nature, made only for proper purposes and be reflected on account records. Policies and procedures should be in effect to govern the department's treatment of overdrafts and to ensure that they are appropriately monitored and kept to a minimum.

Overdrafts can be placed into two distinct categories.

The first category is of less concern because overdrafts are permitted by the terms of the governing instrument and there are no separate income and principal beneficiaries, or the separation of income and principal cash is primarily for tax purposes. In these instances assets shown in the income column, for example, offset a temporary shortage in the principal column. Overdrafts in estates, guardianships and agency accounts generally fall into this category.

In the second category, cash balances in the income column for example, cannot offset a net overdraft in the principal column. This represents a potential liability to the trust department. In most personal trust accounts, the separation of income and principal cash is important because the income and principal beneficiaries may be different persons. Since the trustee may not favor one class of beneficiaries over another, the general rule is that income and principal cash cannot be netted against each other in order to show a combined positive balance. Thus, for example, if the department advances funds to an income beneficiary, thereby overdrawing income cash, and if the income beneficiary dies, the department would have to reimburse the account. In addition, if a trust department improperly nets trust account overdrafts from demand balances held in another department of the savings association, it may be understating its reserve requirements, and therefore in violation of the Federal Reserve Board's Regulation D (see the Thrift Activities Handbook, section 561, reserve requirements). Overdrafts are also a concern when they occur in a custodial account that is actively engaged in the buying and selling of securities without sufficient cash. In these situations, free riding may be taking place. (Refer to the section on free riding if overdrafts are shown for custodial accounts).

For nonfiduciary accounts, such as custodial accounts, savings associations typically charge a rate of interest against the account when the savings association covers overdrafts and the overdraft has occurred as a result of a situation beyond the control of the savings association. Overdraft policies and rates should be disclosed at the beginning of a customer relationship so that customers understand the terms of overdraft coverage. Overdraft rates are generally set at a level expected to provide a reasonable rate of return on the bank's capital and to discourage overdrafts from occurring unnecessarily.

Overdrafts in employee benefit accounts typically occur when savings associations, acting as a trustee or custodian, receive trading instructions from nonaffiliated investment managers of the plan before a prior trade has settled. Although the vast majority of securities transactions settle on time, settlement problems may arise due to unexpected delays, miscommunication, errors or inefficient foreign market practices. It is often operationally impossible, given time constraints, for savings associations to reconcile the cash flows in employee benefit accounts before each transaction clears, instead the settlement process runs continuously. At the end of the day, the accounts are reconciled. If the reconciliation shows that a particular account had insufficient funds when a trade was settled, an overdraft has occurred. The savings association typically covers these overdrafts with its own funds. There is a prohibited transaction class exemption (PTE 80-26), which permits a party in interest to make interest free loans (the payment of the overdraft is considered by the DOL to be a loan) to an employee benefit plan. The party in interest is the savings association. The proceeds of the loan may be used only for certain purposes one of which is to cover temporary overdrafts by a plan trustee to pay for securities or the crediting of dividends or interest by a bank trustee prior to receipt of such dividends or interest. Under the exemption, no interest or other fee may be charged by the savings association to the plan for the payment of the overdraft. Other conditions are that the overdraft may not occur longer than three days and the loan may not be secured.

Consumer Lending Activities

A trust department, on behalf of a trust and asset management account or on behalf of a private banking client, may engage in activities covered by consumer protection laws and regulations. These activities normally arise where the trust department is granting or purchasing loans as a form of investment or in connection with the sale of real estate that is an asset of an account. In some cases, such as under the Truth in Lending Act and its implementing Regulation Z, the consumer protection laws would apply because the trust department is considered to be a "creditor." Under Regulation Z, a person or organization is considered a creditor, and therefore subject to Regulation Z, if it extends consumer credit more than 25 times in the

preceding calendar year or more than 5 times for transactions secured by a dwelling. Each individual account and its trustee (i.e., the savings association) are considered a single (separate) entity for purposes of determining whether it is a creditor.

When the trust department is acting as trustee or recordkeeper for an employee benefit plan, it may be responsible, on behalf of the plan, for complying with Regulation Z disclosures in connection with employee benefit plan loans to plan participants. An employee benefit plan is deemed to be a creditor for Truth in Lending purposes if it regularly extends consumer credit that is payable in more than four installments, or for which the payment of a finance charge is or may be required, and if it is the party shown as the payee on the face of the note evidencing the loan. Truth in Lending requires a plan fiduciary as a creditor to make disclosures to the borrowing participant with respect to certain credit information, including: 1) interest rates; 2) finance charges; 3) amounts financed; 4) payment schedules; 5) demand features; 6) prepayment penalties; 7) late payment fees; and 8) security interest descriptions. The plan must disclose other relevant credit information so that the borrowing participant can compare the various credit terms available to him from different sources. Regulation Z contains extensive guidance as to which fees are considered finance charges, the calculation of finance charges and requirements applicable to open-end credit and closed-end credit. Most, if not all, plan loans will be deemed to be closed-end credit and subject to the Truth in Lending requirements applicable to such credit. A loan over $25,000, not secured by real property or the borrower's principal dwelling is exempted from Truth in Lending requirements. Thus, larger plan loans will be excluded from complying with the disclosure requirements.

In extending credit or dealing in residential real estate investments, a trust department may also be subject to the disclosure requirements of the Real Estate Settlement Procedures Act (RESPA) as well as the laws and regulations related to fair housing and fair lending. The review of these real estate related activities would normally come within the scope of a compliance examination. If that examination is being conducted separately from a trust and asset management examination, appropriate regional area office personnel should be notified of the existence of any of these activities occurring in the trust department.

The trust and asset management examination should determine whether consumer protection compliance considerations are included in trust department policies and procedures, and if no such considerations are apparent, management should be advised to assess the department's possible exposure under the various statutes.

Bank Secrecy Act

The fundamental purpose of The Currency and Foreign Transactions Reporting Act, also known as the Bank Secrecy Act is to provide a paper trail of the activities of money launderers serving the interests of drug traffickers and other elements of white collar and organized crime. To this end, the Act was enacted to discourage the use of currency in illegal transactions and to identify and report unusual or questionable transactions. The requirements of the Act apply to all activities, products and services offered by a savings association's trust and asset management and private banking departments. The BSA requirements typically come into play in regards to wire transfers.

The Bank Secrecy Act regulations (31 CFR §103) require all financial institutions to submit five types of reports to the government whenever certain situations occur. OTS regulations regarding the suspicious activity reports and other reports and statements under the BSA are located at §563.180. Some of the reports that may be applicable to trust department activities are listed below.

- ***IRS Form 4789 Currency Transaction Report (CTR):*** A CTR must be filed for each deposit, withdrawal, exchange of currency, or other payment or transfer, by, through or to a financial institution, which involves a transaction in currency of more than $10,000. Multiple currency transactions must be treated as a single transaction if the financial institution has knowledge that: (a) they are conducted by or on behalf of the same person; and, (b) they result in cash received or disbursed by the financial institution of more than $10,000.
- ***Treasury Department Form 90-22.47 Suspicious Activity Report (SAR):*** Financial institutions must file a SAR for any suspicious transaction relevant to a possible violation of law or regulation.

Financial institutions are also required under the BSA regulations to maintain a variety of records to ensure, among other things, that transactions can be reconstructed. The retention period for all records required to be kept under the BSA regulations is five years. One of the records that trust departments may be required to keep is:

- ***Funds Transfer Recordkeeping and Travel Rule Requirements:*** A financial institution must maintain a record of each fund transfer of $3,000 or more which it originates, acts as an intermediary for or receives funds transfers. The amount and type of information a bank must record and keep depends upon its role in the funds transfer process. Also, a savings association that acts as an originator or intermediary for a funds transfer must pass certain information along to the next bank in the fund transfer chain.

OTS at 12 CFR §563.177 requires savings associations to establish and maintain procedures reasonably designed to assure and monitor compliance with the recordkeeping and reporting requirements established by the Bank Secrecy Act. The BSA compliance program is required to be reduced to writing, approved by the board of directors and reflected in the minutes of the savings association. The compliance program, at a minimum, must: 1) provide for a system of internal controls to assure ongoing compliance; 2) provide for independent testing for compliance to be conducted by a savings association's in-house personnel or an outside party; 3) designate individual(s) responsible for coordinating and monitoring day-to-day compliance; and 4) provide training for appropriate personnel.

Shareholders Communications Act

The Shareholders Communications Act of 1985 gave the SEC authority to regulate the proxy processing activities of banks and all other entities exercising fiduciary powers. This includes savings associations' trust departments that hold securities in nominee name or otherwise on behalf of beneficial owners. SEC Rule 14b-2, which is promulgated under the Securities Exchange Act of 1934, implements the Act. The rules govern the distribution of proxy materials to, and the disclosure of identifying information about, shareholders whose securities are registered in a nominee name. Note that the beneficial owner, for purposes of these shareholder communications rules, is not necessarily the person who owns the security or receives the dividends. For example, a savings association that has the authority, as fiduciary for a trust account, to vote the securities held in the account is deemed the beneficial owner under the rules. Similarly, if an investment manager (savings association) has been assigned the right to vote securities on behalf of a customer, the investment manager (and not the customer) is the beneficial owner, for purposes of this rule.

Essentially, the Rule stipulates that financial institutions must comply with certain requirements to facilitate communications between issuers of registered securities ("registrants") and the holders of those securities ("beneficial owners"). The requirements address proxy distribution procedures and provisions regarding the disclosure of beneficial owner information.

There are several phases in the proxy distribution procedures under Rule 14b-2. Financial institutions are required under the rules to respond to search card requests from the issuers of registered securities (i.e. the corporation or the mutual fund company) to determine beneficial owners in order to send proxies, annual reports and related materials. The financial institution then will distribute the proxy material to their customers, seeking voting instructions from them. Upon receipt of these voting instructions, the financial institution communicates the results to the corporation or the mutual fund company. An exception to these rules applies to employee benefit plans whose participants have pass-through voting powers (Rule 14b-2(c)).

Self-Directed IRA's

Under 12 CFR §550.580, a savings association does not need trust powers to act in a fiduciary capacity regarding certain types of accounts. These accounts include Individual Retirement Accounts within the meaning of Internal Revenue Code 408(a). Under this section, a savings association may act as a trustee or custodian of these accounts (without trust powers) if the IRAs are invested in the savings association's accounts, deposit obligations or securities or other assets as the customer directs. The savings association, may not (without trust powers), in regard to these accounts, offer investment advice or exercise any investment discretion.

Despite the fact that institutions are permitted, within the constraints of state law, to offer these products without trust powers, the accounts are considered fiduciary accounts. The institution is required to treat them as it would any other fiduciary account. In addition, the administration of these accounts must also comply with, as applicable, the Internal Revenue Code, ERISA and state law.

Where savings associations with trust powers offer or provide services to these accounts within the trust department, the accounts and related practices should be reviewed during trust and asset management examinations. Where institutions that do not operate a trust department offer these products, the institution's practices should be reviewed as part of the nondeposit investment products review segment of the safety and soundness or compliance examination. Additional information and guidance are provided in the examination procedures for nondeposit investment products.

Examiners should ensure that sufficient documentation exists to adequately identify and support each account. The assets of these IRAs should be accounted for separately from the savings associations' own assets. The institution's internal audit coverage should include this activity.

Free Riding

"Free riding" generally involves individuals trading large amounts of securities without depositing the necessary money or appropriate collateral in their customer accounts. The customer seeks to free ride that is, purchase and sell the same securities and pay for the purchase with the proceeds of the sale. Targeted investigations in the early 1990s by the Enforcement Division of the Securities and Exchange Commission found banks in violation of Regulation U in connection with extensions of credit (overdrafts) by bank trust departments, using bank or other fiduciary funds, to individuals involved in illegal "day trading" or "free-riding" schemes. Banks were also found to be aiding and abetting violations of two other securities credit regulations: Regulation T and Regulation X.

If the money to pay for the securities is not in the account when the securities are delivered in a delivery-versus-payment (DVP) or receive-versus-payment transaction, a savings association that permits completion of the transaction creates a temporary overdraft in the customer's account. This overdraft is an extension of

credit that is subject to Regulation U. Regulation U includes a requirement that all extensions of credit that are secured by marginable stock be within the 50 percent margin limit set by Regulation U. Savings association involved in free-riding schemes may be aiding and abetting broker-dealer violations of Regulation T. Regulation T applies to broker-dealers only and it requires the use of a cash account when a customer purchases or sells securities on a DVP basis. If a savings association uses its funds to complete a customer's transactions, the broker-dealers may not discover that they are selling securities to the customer in violation of their obligations under Regulation T. Regulation X is also involved in these schemes as this Regulation generally prohibits borrowers from willfully causing credit to be extended in contravention of Regulations T or U.

Free riding often begins when a custodial account is opened with a trust department. The customer also establishes brokerage accounts through which the customer directs securities trades. The customer then advises the broker-dealer that payment for such trades will be made through the custodial account. The perpetrator attempts to profit from short-term changes in market prices of securities, without placing significant personal funds at risk. Free riders frequently place a buy order for securities, anticipating a near-term price increase and intend to pay for the securities with the proceeds from the sale of the same securities.

At a minimum, examiners should evaluate a trust department's ability to ensure that it does not extend more credit on behalf of the banking organization to a customer than is permitted under Regulation U. Any overdraft related to a purchase or sale of margin stock is an extension of credit subject to the regulation, including overdrafts that are outstanding for less than a day. Examiners should also make sure that savings associations follow appropriate written policies and procedures concerning the establishment of custodial agency accounts or any new account involving customer securities transactions. Such policies and procedures should:

- Set standards for the acceptance of new custodial accounts, including customer background, credit information and a determination of whether the customer will be obtaining bank credit to use the account as if it were a margin account. The institution should inquire, if the customer has indicated that it will be obtaining bank credit, why the customer is not utilizing the margin account services of its broker-dealer. If the account is to be used as a margin account, Regulation U Form FR G-1 must be obtained and constantly updated.
- Require identification of the broker-dealers that will be sending securities to and receiving funds from the account on a DVP basis. The institution should establish systems to track accounts involving numerous broker-dealers.

The institution should require, as part of its account agreement that the customer will take responsibility to make sure that all account transactions with broker-dealers will be in conformance with Regulations T and X.

State Escheatment Laws

Escheat is defined as a reversion of property to the state in consequence of the lack of any individual qualified to inherit the property. In trust departments the issue will generally arise concerning unassigned dividend or interest payments; bond coupons not presented for payment; bonds not presented for payment; uncashed employee benefit plan participant distribution checks; and certain suspense account assets. Trust departments acting as bond trustees, securities transfer agents, and paying agents should consult state abandoned property laws for: (1) checks and securities certificates which are undeliverable and (2) book-entry accounts for which the owner cannot be located. Escheat laws vary from one state to another. They

will normally be found in state statutes under titles such as "unclaimed property" or "abandoned property." In some instances, one state may claim its escheat laws apply to dormant funds also claimed by another state.

It is important that the trust operations area have some procedure in place to assure compliance with these laws. Examiners should familiarize themselves with relevant state law on the issue of escheatment and be alert during examinations to qualifying stale items and other instances where such law might be applicable.

Examiners should note that outstanding checks issued by an employee benefit plan for distribution to plan participants or for other purposes, are, according to the Department of Labor, never subject to state escheatment laws. The Department of Labor takes the position that outstanding checks represent plan assets that can never be escheated. The DOL has claimed preemption over state escheatment laws in a number of advisory opinions issued over the years.

Pledge Requirements

12 CFR §550.310 requires that trust funds on deposit with the institution or an affiliate awaiting investment or distribution must be fully collateralized if they are in excess of FDIC insurance coverage. The types of acceptable collateral for uninsured deposits are detailed in 12 CFR §550.320. This requirement pertains to all deposits of fiduciary account assets with the institution or an affiliate, including demand deposit accounts, certificates of deposit, money market deposit accounts and savings accounts. The institution should adopt and implement procedures, which ensure the periodic review of the adequacy of any collateral pledged in accordance with these regulations.

To illustrate, the calculation of collateral for a single account with a single beneficiary involves adding the account's net demand deposit balance; any outstanding checks drawn on that balance; any funds awaiting investment or distribution deposited in interest-bearing accounts (as opposed to invested funds); and any funds of the account held in suspense or other in-house accounts. The totals of all individual accounts in excess of insurance limits can then be added together to determine the minimum necessary collateral for a particular day.

Custodial Holdings of Government Securities

A succession of highly publicized failures of government securities broker-dealers that caused large losses to investors occurred from the mid-1970s to the mid-1980s (e.g., Drysdale, Lombard-Wall, E.S.M.). As a result of these failures and improper practices, Congress exercised its authority over the largely unregulated government securities market through passage of the Government Securities Act of 1986 (GSA). The stated purpose of the GSA and its implementing regulations is to enhance the protection of investors in government securities by establishing and enforcing appropriate financial responsibility and custodial standards.

The GSA applies to all financial institutions that engage in government securities activities. For the purposes of the GSA, government securities include:

- U.S. Treasury bills, bonds and notes;
- Discount notes, bonds, certain collateralized mortgage obligations, pass-throughs, master notes, obligations of the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), the Student Loan Marketing Association (SLMA), the Farm Credit System (FCS) and the Financing Corporation; and

- FNMA or FHLMC stock.

"Off-exchange" puts, calls, straddles and "similar privileges" on government securities are considered to be government securities except for the rules addressing custodial holding of securities.

The GSA requirements impact savings associations (referred to in the law and regulations as financial or depository institutions) in three main areas:

- Savings institutions that are government securities brokers or dealers are required to file a notice with the Office of Thrift Supervision of their status as such by the date of their becoming a government securities broker or dealer and to comply with applicable requirements relating to those activities.
- Savings institutions that engage in repurchase transactions with customers while retaining custody or control of government securities ("hold-in-custody" repurchase transactions) must comply with requirements relating to written agreements, confirmations and disclosures.
- Savings institutions that hold government securities for customers, as fiduciary, custodian or otherwise, must comply with requirements relating to the safeguarding and custody of those securities (17 CFR §403.5). The GSA regulation applies whether an institution holds the customers' securities directly or maintains the customers' securities through another institution. A "customer" is any party for whom the institution maintains government securities.

This handbook section covers the holding of government securities in fiduciary or custodial accounts. More information on the other requirements under the Government Securities Act is covered in Section 563 of the Thrift Activities Handbook.

The regulations at 17 CFR §403.5 note that there is an exemption at 17 CFR §450.3 regarding the holding of government securities in fiduciary accounts. This exemption only applies to banks, not savings associations regulated by the OTS. Until such time as that exemption becomes available to savings association, savings associations must comply with the requirements contained in Part 450 of the GSA regulations.

References below are to the applicable GSA regulations.

Possession and Control Requirements (450.4(a))

All government securities held for customers must be (1) segregated from the savings association's own assets and (2) kept free of any lien or other claim by a third-party granted or created by the savings association. For securities maintained for the savings association at another depository institution ("custodian institution), compliance of the above requirement is achieved if: the savings association notifies the custodian institution that such securities are customer securities; the custodian institution maintains the securities in an account that is designated for customers of the savings association and that account does not contain any securities belonging to the savings association itself; and the savings association instructs the custodian institution to maintain the securities free of any lien, charge or claim of any kind in favor of the custodial institution.

Thus, if a savings association is maintaining both custodial and fiduciary customers' securities and its own securities at a custodial institution, it must have at least two accounts at the custodial institution: one for holding custodial and fiduciary customers' securities and one containing its proprietary securities.

Notwithstanding the possession and control requirements, a savings association may lend securities to a third party pursuant to the written agreement of the customer if such loan complies with the supervisory guidelines of the OTS.

Confirmation Requirements (450.4(b))

A confirmation or safekeeping receipt must be issued to a customer for each government security held. The confirmation or safekeeping receipt must identify the issuer, maturity date, par amount and coupon rate of the security being confirmed. A savings association shall not be required to send the confirmation or safekeeping receipt to a customer that is a non-U.S. citizen residing outside the U.S. or a foreign corporation, partnership, or trust, if such customer expressly waives in writing the right to receive such confirmation or safekeeping receipt.

Recordkeeping Requirements (450.4(c)-(f))

A records system of government securities held for customers must be maintained separate and distinct from other records of the savings association. These records must (1) identify each customer and each security held; (2) describe the customer's interest in the security (i.e., "subject to repurchase agreement" or "pledged to secure a public deposit"); and (3) indicate all receipts and deliveries of securities and cash in connection with the securities. A copy of the safekeeping receipt or confirmation given to customers also must be maintained and the system of records must provide an adequate basis for audit. Finally, the required records must be maintained in an easily accessible place for at least two years and not disposed of for at least six years.

Verification Requirements (450.4(d))

A savings association is required to conduct a count of physical securities and securities held in book-entry form at least annually. An annual reconcilement with customer account records must also be performed. The savings association responsible for the count must verify any securities in transfer, in transit, pledged, loaned, borrowed, deposited, etc. when the securities have been out of the savings association's possession for longer than 30 days. The dates and results of the counts and reconcilements must be documented within seven days of the required count with any differences noted.

Securities Subject to Repurchase Agreement (403.5(d))

All financial institutions that retain custody of securities sold under an agreement to repurchase must comply with the requirements for hold-in-custody repurchase agreements. If the customer agrees to allow substitution of securities in a hold-in-custody repurchase transaction, then authority for the savings association to substitute securities must be contained in the written repurchase agreement. In all hold-in-custody repurchase agreements where the savings association reserves the right to substitute securities, a specific disclosure statement must be prominently displayed in the written repurchase agreement immediately preceding the provision allowing the right to substitution. A savings association must disclose to the customer in writing that the funds held pursuant to the repurchase agreement is not a deposit and therefore not federally insured. Written confirmations describing the specific securities subject to the transaction must be sent to the customer by close of business on the day the transaction is initiated, as well as on any day on which a substitution of securities occurs. In addition to the specific information discussed above under "confirmation requirements," confirmations must include the market value (defined as the most recently available bid price for the security, plus accrued interest) and CUSIP or mortgage pool number of

the underlying securities (unless identified in internal records of the broker-dealer). Finally, pooling of securities, as collateral for repurchase agreements are no longer permitted.