

Introduction to Asset Management

Asset management relates to the selection, retention and preservation of trust and asset management account assets. It entails an understanding of the concepts of risk, return, diversification and portfolio efficiency, along with the need to meet specific account objectives. The potential investment vehicles for consideration by savings associations with investment discretion over fiduciary account assets have expanded considerably in recent years, which has increased the need for savings associations to acquire personnel with knowledge of, and skills relating to, the diverse investment world.

The examiner's evaluation of asset management should consider the adequacy of the discretionary account asset investment process. Examiners should also focus on the overall risk management process by which a department evaluates assets held in trust and asset management accounts; the specific process by which it selects assets to be purchased, retained or sold; and the sufficiency of documentation on file to support those investment decisions.

The trust department's asset management activities subject it to reputation, strategic and compliance risks. In addition, each individual account or portfolio managed by the savings association is subject to price, credit, liquidity, interest rate and foreign exchange risk. The examiner must assess management's ability to identify and control these risks. Also considered in the examiner's evaluation is the adequacy of asset management policies and procedures; management's decision making processes for discretionary investments; the quantitative tools used to monitor and control discretionary investments; the asset review process; and management's due diligence efforts in evaluating and monitoring investment advice, brokerage placement and investment research. The evaluation is the same whether these functions are performed in house or outsourced to a third-party.

Asset Management Constraints

The asset administration function is subject to several constraints such as, the specific investment requirements outlined in the governing instrument; applicable law, that will include state prudent investment statutes; generally accepted fiduciary principles; and finally, account objectives and goals. Within the confines of these constraints, however, a savings association with investment discretion is given a reasonable degree of flexibility to exercise its investment responsibilities. It is important to note that the savings associations exercising investment discretion should have an effective oversight system to ensure that all investment activities and risks are properly identified and controlled.

Governing Instrument

The primary investment guidance is the governing instrument. Although each individual instrument is unique, most accounts have governing instruments that contain standardized clauses. These clauses generally indicate that permissible investments are those made in accordance with applicable state law. Specialized investment clauses of a governing instrument can detail various types of unique or specialized investment purchases or retentions. Some of the most common investment clauses include authorization for investment in affiliated products or stocks or specific permission or prohibitions regarding the purchase or sale of a particular type of security, industry segment or asset category. Close attention must be paid to the requirements outlined within the governing instrument, as failure to do so can result in a breach of fiduciary duty and subject the savings association to litigation and financial loss.

Statutory and Regulatory Requirements

The asset administration function is subject to various state and federal laws and regulations. The specific OTS requirement for the investment of fiduciary assets is contained in 12 CFR §550.260, which provides that a fiduciary is to invest funds in a manner consistent with applicable law. Thus, a fiduciary must be able to demonstrate that it acted properly under the provisions of applicable law, which includes the governing instrument. If its actions are contrary to those provisions, a fiduciary is exposed to potential litigation.

The responsibilities of a savings association will vary depending on the type of account. When a savings association has discretion to select investments for an account, all such selections must comply with applicable law and be suitable to the needs of all account beneficiaries. When a savings association has no investment discretion, its sole responsibility is to follow the direction of the party(s) designated as having such power in the governing instrument. An exception to this exists for employee benefit accounts subject to ERISA. According to the Department of Labor, a directed trustee has residual fiduciary responsibility for determining whether a given direction is proper and whether following the direction would result in a violation of ERISA.

In most instances there will be no specific statutory requirement or language in the governing instrument that will specify the types of investments a savings association with investment discretion may choose as appropriate investment vehicles. The savings association, in these circumstances, must choose investments that are suitable for the account and meet account objectives. This should be done in accordance with the principle of prudence. The specific prudent investing guidelines will depend on the applicable state statute governing the account or in the case of employee benefit accounts, the prudent investing rules of ERISA.

Asset Management Duties

A savings association with investment discretion has a duty to invest trust and asset management account assets with prudence. There are two generally accepted rules addressing the duty of prudence; the prudent person rule and the prudent investor rule.

The prudent person rule is based on common law and is the result of the 1830 Massachusetts court decision - Harvard College v. Amory, 9 Pick (26 Mass), 446 (1830). This rule was the prevailing approach for many years in evaluating the prudence of investment choices. The rule provides that a fiduciary is under a duty to exercise such care and skill in making investments as a person of ordinary prudence would exercise in dealing with his or her own property, under the same circumstances prevailing at that time. The prudent person is further required to manage the property in terms of the permanent disposition of the funds, considering the probable income as well as the probable safety of the capital to be invested. A prudent person cannot speculate with property belonging to another person. Put another way, the fiduciary must exercise a reasonable degree of care in selecting investments, always considering the preservation of the funds. Both statutory and common law generally impose a higher standard of care, skill and caution on a corporate fiduciary than is imposed on an individual fiduciary.

The American Law Institute's Third Restatement of the Law of Trusts adopted the prudent investor act in 1990. This rule reflects a "modern portfolio" theory approach to fiduciary investments. The majority of states have adopted a version of this rule. Under the rule, the trust account's entire investment portfolio is considered when determining prudence and a fiduciary will not be held liable for individual investment losses as long as there is appreciation in the overall portfolio. The rule states that even an investment or technique that appears risky in isolation may play a role in an investment strategy as long as the trustee considers and weighs the purposes of the trust and the types of investments suitable for that purpose.

No type of investment is deemed to be inherently imprudent. Therefore, a trustee is not prohibited from using certain investments as long as they are used in a manner that is designed to achieve a higher level of return, without a disproportionate increase in the overall level of risk. An important component of this type of investing, according to the prudent investor rule, is diversification. Another important difference between the prudent investor and the prudent man rule is that the delegation of investment and other management functions to third parties is sanctioned under the prudent investor rule.

Employee benefit accounts subject to ERISA are governed by the prudence requirement of ERISA §404(a)(1), as well as by the regulation 2550.404a-1, which establishes a federal prudent investor rule similar to the one outlined above.

There are other asset management duties that arise as a result of entering into a fiduciary relationship. One of the most fundamental duties of a fiduciary is to act for the exclusive benefit of the trust account. This is known as the duty of loyalty. While the fiduciary has equitable ownership of the assets placed in its care, the fiduciary is accountable to the trust and ultimately to the beneficiaries for the management of those assets. Thus, while the fiduciary can buy, hold or sell the property, all benefits arising from the ownership of the property must accrue to the trust. In terms of asset administration, the duty of loyalty prohibits the fiduciary from engaging in any acts of self-dealing or other impermissible conflicts of interest. All asset management activities must be conducted for the exclusive benefit of the account.

Another fiduciary duty relating to asset administration is the duty to dispose of improper investments. For example, if assets originally used to fund the trust do not meet the quality standards outlined in the savings association's investment policy or do not assist in meeting the account objectives, a fiduciary is under a duty to dispose of them within a reasonable timeframe.

Finally, a fiduciary is under a duty to act impartially among the beneficiaries, with regard to the respective interests of each class of beneficiaries. For example, the fiduciary has a responsibility to the income beneficiary not only to preserve the property but also to make it productive so that a reasonable income will be available. In addition, the fiduciary is under a duty to the remainder beneficiary to preserve the principal of the trust property.

Supervision, Oversight and Risk Management

The responsibility to manage the assets of others exposes the savings association to several unique risks. The risks are inherent in each asset of the account portfolio. They include, price, liquidity, credit, interest rate and foreign exchange risk. Other risks include compliance/legal and transaction/operational risk. A savings association should manage its exposure to these risks by having effective supervision, oversight and risk management programs. These programs should provide management with information to identify and control the risks of their asset management activities. Without such systems and information, the savings association may be unaware of its risk level and the exposure that may result from beneficiary complaints, lawsuits and ultimately damaged business reputation.

The goal of the supervision, oversight and risk management programs is not to eliminate risk but to identify and control that which can be controlled. Not all risk can be eliminated, nor should it. The role of the asset management function is to achieve the account objectives by managing the risk/return equation to achieve the highest level of return given a certain level of risk. A fiduciary must employ the investment prudence standards outlined above and recognize that risk and return are directly related.

The identification and control of risks in asset management activities is ultimately the responsibility of the board of directors. Therefore, the board should have developed and implemented policies that establish the level of risk that will be acceptable to the institution. A well developed, all inclusive investment policy that outlines the types of assets to be employed, as well as the requirements for monitoring and reporting, is required. Equally important is establishing a process to ensure that asset management personnel know and follow the board approved investment policy. This process may be incorporated into the institution's audit program, compliance function and/or risk management program. However the process is conducted, it should provide for monitoring, and reporting, of both the investment policy's effectiveness in controlling risk, as well as identify areas where risk is increasing.

To assist in identifying and controlling risk, management information systems and reports are needed. Such reports will provide information regarding investment performance, compliance with account objectives, identification of high-risk areas, compliance with investment policy, compliance with law and regulation, asset reviews, etc. The information presented in such reports should be used to develop or revise existing procedures for controlling risk. Management must also ensure that procedures and approved practices are being implemented. The use of an audit, compliance or risk management process will assist in conducting the reviews, as well as producing management reports.

Investor Objectives

Although the asset manager is guided by the requirements outlined in the governing instrument, applicable law and sound fiduciary principles, there are other factors that should be considered. Every account will have certain investment objectives and constraints that are unique. The fiduciary must take these into consideration when conducting asset management activities and exercising its investment discretion. Then there are other constraints that are relevant to all fiduciary accounts. These include the need for liquidity; investment return; tolerance for risk; investment time horizon; tax considerations; and the unique needs, circumstances and preferences of the account beneficiaries. The fiduciary must also take these into consideration when making investment decisions.

Investment Policy

Another responsibility of the board of directors is the proper exercise of all fiduciary powers, including those relating to asset management. As stated in 12 CFR §550.150(a), the exercise of fiduciary powers must be managed by the board of directors. In order to demonstrate compliance with this requirement as well as with the other fiduciary duties associated with asset management, the association must have a written investment policy as outlined in 12 CFR §550.140(e) that has been approved by the board of directors. The basis of any investment policy should be sound fiduciary principles, including prudence, preservation of capital, diversification and a reasonable level of risk. The investment policy should clearly outline the parameters for all discretionary fiduciary investment activities and at a minimum contain the elements listed below.

- ***Overall investment philosophy and the standards of practice.*** A general statement as to the investment style and approach should be outlined in the board approved policy, along with a discussion on what practices and standards will be implemented to achieve the desired result.
- ***Management's expected code of conduct for employees, officers and directors who by their duties have asset management responsibilities.*** The policy should discuss the ethical standards and disclosure of individual trading through approved brokers that are to be followed by all individuals with investment and asset management responsibilities, as well as outline the consequences for violations of the policy.

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- ***Functions and responsibilities of officers and committees involved in the asset management process.*** The policy should specifically identify the functions to be performed by asset management personnel, as well as the responsibilities of any committees.
 - ***Standards and procedures used to evaluate and monitor asset quality.*** The policy should outline the process and criteria for selecting and evaluating potential investments as well as monitoring existing investments. The process should review for investment performance using risk parameters and comparisons to appropriate benchmarks. The process should outline the documentation required for all investment decisions.
 - ***Overall portfolio guidelines including, as appropriate, percentage distribution among types of assets relative to the account objectives.*** The policy should outline general distribution parameters for the asset types in accordance with general categories of account objectives.
 - ***Diversification requirements, both overall and in terms of the maximum percentage to be invested in any one security or industry segment.*** The policy should outline the general diversification requirements for asset administration, as well as the process implemented to monitor and control deviations from policy guidelines.
 - ***Guidelines for conducting asset reviews.*** The policy should outline the standards and procedures for conducting initial and annual asset reviews, along with the monitoring and documentation requirements.
 - ***Standards and procedures for the acceptance and disposition of substandard assets.*** The policy should outline the criteria for accepting and monitoring assets that do not assist in meeting account objectives. Specifically, the policy should outline the requirements for developing and implementing disposition plans for assets that are not part of the account's overall investment strategy.
 - ***Standards and procedures for developing and amending approved lists of investments.*** If the savings association uses approved lists, the policy should outline the criteria for the selection and monitoring of such investments, as well as a description of the overall process for additions and deletions to the lists.
 - ***Conformance of assets purchased, retained or sold with department's list of approved assets, and procedures for any exceptions.*** If the savings association uses an approved list of assets for investments, the monitoring process for all deviations from such lists should be outlined in the policy.
 - ***Guidelines and procedures for the administration of unique and miscellaneous assets.*** The policy should outline the process for the purchase, sale and/or retention, as well as the administration of unique assets such as life insurance policies, real estate, closely held companies, limited partnerships, mineral interests, loans, etc. The process should discuss the risks associated with each type of asset and outline the appropriate level of control for administration.
 - ***Guidelines and standards for the prompt investment of income and principal cash.*** The policy should outline the process to address the fiduciary duty to make trust assets productive, including the treatment of funds awaiting investment or distribution. Procedures for overall cash management should be established.
 - ***Guidelines and standards pertaining to the use of overdrafts.*** The policy should outline the authorization and clearance requirements, including dollar and time limits.
 - ***Guidelines and standards regarding the selection and use of broker/dealers in regards to brokerage placement practices.*** The policy should ensure "best execution" practices are established and provide for periodic assessment and comparison of brokers utilized as well as the receipt of soft dollars.

- *Compliance with federal securities laws, particularly those dealing with the handling of material inside information.*
- *Guidelines and standards for voting proxies, particularly in regards to investments in the savings association's own securities or proprietary mutual funds.*
- *Guidelines and standards for investments in affiliated products, including the use of insurance products, proprietary mutual funds and funds in which the savings association, its subsidiaries or affiliates receive a benefit.* The policy should outline the process for selecting and monitoring these products as investments, as well as all state law requirements.
- *Safeguards against conflicts of interest and self-dealing.*

Delegation of Investment Responsibility

In those instances where the savings association has delegated its investment responsibility to a third party, the trust department should have a policy outlining the decision-making process, the activities to be outsourced and the criteria for selecting and monitoring these third parties. While current OTS fiduciary regulations do not specifically address the delegation of investment responsibility, they do contain language regarding the hiring of other entities to perform fiduciary activities. Specifically, 12 CFR §550.180 states in part:

...You [Savings Bank] may also purchase services related to the exercise of fiduciary powers from another association or other entity under a written agreement.

This provision provides that a savings association can enter into a written contract with other entities to obtain assistance in providing its fiduciary duties. When entering into such contracts, the trust department should ensure that the following conditions are addressed:

- activities to be performed by the third party must be permissible under applicable law and must be limited to those activities that the savings association itself could perform;
- the savings association cannot delegate any fiduciary activity that would result in strict liability for the acts of the third party;
- the services provided by the third party must be in accordance with 12 CFR Part 550 and any other applicable law;
- the savings association must oversee and monitor the performance of the third party services and the third party must provide the savings association with adequate records and information from which trust management can monitor the services performed by the third party;
- the services provided by the third party must be in a written agreement and negotiated at arms' length; and
- the services performed by the third party must be in the best interests of fiduciary customers.

The savings association should then look to applicable state law for additional guidance on this matter. If the applicable state's statute is some version of the prudent person rule, a trustee would not be able to delegate its investment responsibility/liability outside the trust department. The savings association can employ an outside party to provide it with investment advice in managing its trust account portfolios. However, the outside party is merely providing the savings association with investment advice; it is still the responsibility

of the trust department to actually make the investment decision to either: (1) adhere to the adviser's advice; (2) reject it; or (3) make an alternative decision/selection. Under the prudent person rule the savings association will continue to maintain full liability over the results of its agent's actions, guaranteeing to make up any losses that the trust account may incur due to the negligence or misconduct of the agent.

The prudent investor rule differs from the prudent person rule in that it permits a trustee to delegate its investment liability. In some cases, it may even require the trustee to delegate the investment management responsibility to another party. For example, if a trustee is granted investment duties by the governing instrument and it does not have the expertise in house to perform that function, it may be violating its fiduciary duties if it does not contract with an investment professional to provide that service. However, if a trustee decides to delegate this function to another party, the prudent investor rule imposes certain standards of care that the trustee must adhere to. When delegating the investment responsibility function, the trustee must exercise skill, care and caution in:

- determining the scope and terms of the delegation;
- selecting the agent; and
- supervising and monitoring the agent's performance.

All states have adopted either one of the uniform rules, in whole or have modified the rule to some degree, so savings association need to carefully check the applicable state prudent investment statute to determine if delegation is permitted under state law. If the governing instrument is silent as to a trustee's ability to delegate certain duties, then state law would control the trustee's ability to delegate certain fiduciary functions.

Brokerage Placement Practices

A savings association providing asset management services to fiduciary accounts is required by 12 CFR §550.140(a) to have a policy addressing the practices used for brokerage placement. Prior to conducting any security transaction, the savings association must have knowledge of the securities firm and the personnel with whom they will be dealing. The policy should set the minimum standards for the selection and use of a security broker-dealer. Standards and criteria should be established for the following:

- strength, quality and reputation of management;
- financial strength, including operating results and adequacy of capital and liquidity;
- information from securities regulatory organizations concerning past and current enforcement actions against the dealer or its personnel, including the action taken to correct the deficiency; and
- price and execution considerations.

In some instances, broker-dealers may provide benefits to the savings association in consideration for the trading activity the savings association is providing to the broker-dealer. These benefits are normally referred to as "soft dollar" arrangements. A savings association can enter into such arrangements as long as the benefits conform to the requirements of Section 28(e) of the Securities Exchange Act of 1934. This provision provides "safe harbor" protection if certain conditions are met. The savings association should be able to demonstrate that the amount of the commissions paid to the broker-dealer was commensurate and reasonable in relation to the value of both the brokerage and research services provided. It is the responsibility of the savings association to ensure that the soft dollar benefits obtained from the broker-dealer benefit the accounts paying the brokerage commissions.

Sources of Fiduciary Liability

The savings association is held to a high standard of prudence and expertise in the asset management process. It is therefore essential that trust departments have policies, procedures, processes and expertise to administer the types of assets held in accounts for which they have responsibility. The following is a list of the most common areas that have resulted in surcharge and loss to financial institutions for violations, weaknesses or deficiencies in the asset administration function.

- Failure to follow and adhere to the terms of the governing account instrument
- Failure to follow applicable laws and regulations regarding investments
- Failure to ensure that investments in a directed account conform to the instructions received
- Abuse of fiduciary's discretion in purchasing, retaining or selling investments
- Failure to conduct asset reviews or to adequately document such reviews
- Failure to maintain impartiality among beneficiaries
- Failure to adequately diversify investments
- Failure to develop and plan to dispose of unsuitable assets in a timely manner
- Engaging in self-dealing or other conflicts of interest

Introduction to Portfolio Management

Most savings associations use a team approach when engaging in portfolio management activities. However, the two key players in the portfolio management process are the account portfolio manager and the account administrator. The portfolio manager is responsible for the account investments. In fulfilling this responsibility, the portfolio manager must choose investments that are suitable for the account. In making these choices, the portfolio manager keeps in mind the investment management objective for the account while operating within defined risk parameters. In order to achieve the identified objectives, each account's needs should be defined as specifically as possible. These needs and the account objectives are generally identified by the account administrator. Once the needs have been established and the account objectives identified, the portfolio manager can then design a portfolio that will achieve the desired rate of return, keeping within an acceptable level of risk.

Determining Account Objectives

The account administrator must determine the objectives of the account. This can be accomplished through a combination of discussions with the settlor and other interested parties, as well as a review of the governing account instrument. In order to establish the account objectives, the account administrator must first determine the specific income requirements and needs of the account and/or the beneficiaries.

The account administrator must carefully consider the amount of income that the beneficiaries need from the account. Although guidance for a specific amount may be found in the governing instrument, most instruments simply provide that the beneficiaries should receive income sufficient to maintain a standard of living to which they have grown accustomed or that sufficient income be generated to meet the ascertainable standards of health, education, maintenance and support. In order to determine this amount, the account administrator must be aware of the beneficiary's current financial condition, including the beneficiary's current and future expenses as well as income from other sources. Also important in determining the income requirements, are the interests of the remainder beneficiaries in preserving and increasing the principal of the account. All this information must be weighted together and certain conclusions reached which is then passed on to the portfolio manager to devise an investment strategy that meets the needs of the account.

Designing the Portfolio

In designing a mix of assets for an account, the portfolio manager must consider the timing of probable distributions from the account. For example, if the account beneficiary is elderly or disabled, then the portfolio should contain enough liquid assets to meet expected medical expenses.

It may be in the best interest of a beneficiary to minimize income, estate and generation-skipping taxes and the portfolio manager should design a portfolio accordingly. For example, tax-sheltered investments such as municipal bonds may be more appropriate for an account whose beneficiaries are in a high tax bracket, other considerations being equal. Although the tax consequences of retaining, purchasing and selling investments should not be the primary determinant for investment decisions, the tax consequences of such actions may be significant and the portfolio manager should be aware of such effects.

Investment objectives should, to the extent possible, be related to the age of the beneficiaries and the expected duration of the account. Establishing long-term investment goals for fiduciary accounts, which terminate within a relatively short period, would be inappropriate. For example, an account that will remain

in existence through several levels of beneficiaries (spouse, children, grandchildren) should ordinarily have different investment objectives than an account that will terminate within a short period of time.

There are various investment strategies that may be utilized by a portfolio manager to achieve the objectives of an account. If the account's objective is to minimize risk, then a conservative strategy will provide stability of income and principal and will also allow as much opportunity for appreciation as is consistent with that objective. If the objective is to provide large financial returns to the account, then a more aggressive strategy will provide higher yields or principal appreciation; however, this strategy requires a greater degree of risk and wider tolerance for losses to achieve the objective. Attainment of these or other objectives can in most cases be best achieved by adopting specific investment vehicles or an appropriate mix of those vehicles. The portfolio manager should carefully document the decision-making process to show how the chosen investment strategy will achieve the stated goals of the trust account.

Next, the portfolio manager must implement the investment strategy. The implementation should correspond closely to the initial review of assets required by 12 CFR §550.210, one purpose of which is to compare assets used to fund the trust or received from a prior trustee for suitability and compatibility with the needs of the account. Assuming some restructuring of the portfolio is necessary, the portfolio manager should develop and implement a systematic program for retaining assets, purchasing appropriate assets and/or disposing of assets that are unsuitable for achieving the investment objectives. This restructuring may involve an extended time period so as to avoid sharp initial losses, take advantage of market timing or avoid adverse tax consequences, such as large capital gains. Documentation of the decision-making regarding the restructuring process is a good risk management practice.

Asset Review

One of the most important steps in the asset management process is the review and monitoring of the approved account objectives and investment strategies. Compliance with the agreed upon objectives and investment strategies is an important aspect to monitoring and controlling risk to both the individual account and the savings association. Both the objectives and the investment strategies must be periodically reviewed and monitored in order to determine conformance. The process should include a review of the account's objectives to ensure that they remain valid in light of current circumstances or developments. The overall investment portfolio, as well as the individual assets held in the portfolio must be reviewed to determine if they conform to the investment strategy designed to meet the account objectives.

By way of illustration, an asset review will normally consider the following:

- account objectives and beneficiary needs for continued applicability;
- characteristics of the overall portfolio, for conformance with account objectives;
- transactions since last review, for accuracy and conformance with objectives and department policies and procedures;
- asset holdings, for adequacy (e.g., rate of return, risk attributes, quality, asset mix, diversification); and
- future needs of the account, for liquidity (e.g., anticipated or unusual expenses or distributions).

The frequency of an asset review for individual accounts should be based on the volume and complexity of the department's overall business as well as the complexity of a particular account. For example, most accounts may be set up for an annual review but specific accounts, due to the nature of their holdings, may need to be reviewed more frequently. 12 CFR §550.200 - 220 establishes the outer limits of an asset review,

by requiring that such reviews be conducted promptly after the account has been accepted and at least once during every calendar year thereafter.

Types of Investments

There are various investment vehicles available for the investment of trust account assets. With the increased use of the “modern portfolio theory” and the majority of states adopting some version of the uniform prudent investor rule, no single investment within a portfolio is considered to be per se imprudent. It is the overall portfolio holdings or the overall investment strategy that can be considered imprudent and subject to examiner criticism, beneficiary complaints or lawsuits.

There are many types of investments that may be found in a trust department of a savings association. Some of these investments are described in the narrative sections attached to a specific examination program. One type of investment not described elsewhere is a cash management instrument.

Cash Management Instrument

A savings association may provide various instruments for the short-term investment of idle cash. As fiduciary, the savings association is responsible for making all assets productive, even those assets awaiting investment or distribution, as outlined in 12 CFR §550.140(e). Given the current technology and the prudent investor standards, there are few defenses for fiduciaries that permit idle cash to remain unproductive and not invested. There are several vehicles available for managing short-term investments. These instruments can include money market funds, sweep arrangements and deposits. The use of these instruments should be for short-term purposes and be appropriate for achieving the overall investment objective for the account.

Money market funds are a type of mutual fund that has relatively low risks compared to other mutual funds. They are limited by law to certain high-quality, short-term investments. Money market funds try to keep their value net asset value (NAV) at a stable \$1.00 per share but the NAV may fall below \$1.00 if their investment performs poorly, in which case management should be aware of “breaking the buck.” Investor losses are rare but they are possible. Some of the more common investments held in these funds include time deposits of financial institutions, commercial paper, bankers acceptances and short-term U.S. Government or agency obligations.

Another alternative for achieving the investment of idle cash is the use of a sweep arrangement. This arrangement allows the fiduciary to automatically invest all cash into an interest earning short-term investment. In most instances the investment is a money market fund. The investment instrument into which the cash is swept should be reviewed on a periodic basis to ensure appropriateness.

Deposits are another alternative, however, given the number of other available alternatives, the use of deposits should be limited. Deposit investments can be with the same institution conducting the fiduciary activities, however this does create a conflict of interest and should only be permitted when allowed by applicable law.

Portfolio Management Examination Program

Examination Objectives

To determine the adequacy and/or effectiveness of the trust department's investment of trust and asset management account assets. Consider whether:

- policies and procedures are in place to ensure compliance with governing instruments, applicable law and accepted fiduciary principles;
- the investment selection and review processes are designed to meet account objectives as well as comply with investment policies and procedures;
- portfolio management risks are identified, measured, monitored and controlled;
- investment decisions are adequately documented; and
- deficiencies are identified and corrective action is promptly initiated.

Examination Procedures

Wkp. Ref.

Level I

Level I procedures first focus on a review of the examination scoping materials. The next step consists of interviews with trust department personnel to confirm their qualifications and levels of expertise; to determine if the trust department's practices conform to written guidelines; to establish whether any significant changes in personnel, operations or business practices have occurred; or whether new products and/or services have been introduced. If items of concern are uncovered during a Level I procedure or if problems are identified during the preexamination monitoring and scoping, the examiner may need to perform certain Level II procedures.

1. Review examination scoping materials related to the portfolio management of account assets. Scoping material should include:
 - Risk profile
 - Relevant PERK documents
 - Previous trust and asset management examination report
 - Workpapers from the previous examination

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- Safety and soundness examination report
- Recent ADV and any amendments
- Board of director and other appropriate committee minutes
- Examination reports of subordinate, functionally regulated entities
- Savings association's web page

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2. Evaluate the trust department's policies and procedures related to the investment of account assets. Note any significant changes. Consider whether the policies and/or procedures:
- require account investments to be reviewed at least each calendar year to determine if they meet account objectives;
 - are communicated to appropriate personnel; and
 - require a review of investments to determine if churning or other similar trading practices have taken place.
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3. Determine if management has delegated investment authority or other asset management responsibilities to a third party. Assess the due diligence efforts with respect to the selection of the third party, and determine if applicable law permits such delegation. Ensure that the savings association has written agreements outlining the duties, responsibilities and obligations of the involved parties.
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4. Evaluate how management monitors the performance of all third party service providers providing asset management services.
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5. Evaluate management's expertise and ability to properly supervise the asset administration function. Note any significant personnel and/or organizational changes.

6. Review the process for establishing account investment objectives and implementing strategies to achieve the objectives.

7. Review portfolio allocation models and determine if they are reasonable based on applicable investment objectives.

8. Evaluate any new investment product or service, noting whether appropriate policies and procedures have been implemented. Also, note whether there is an appropriate level of expertise available in regards to these new products and services.

9. Review the trust and asset management account master investment list. Note any changes in overall asset composition as well as significant holdings in any one security or market sector. Compare this against lists obtained in prior examinations. Determine the cause of any significant change and assess if it presents undue risk to the savings association and/or the involved discretionary accounts.

10. Ensure that deficiencies outlined in the prior examination were sufficiently addressed by management.

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11. Consider whether the following risk contributors (if applicable) have been addressed:
- Does management fully understand all aspects of portfolio management and investment risk?
 - Does management anticipate and respond well to market and technological change?
 - Do management information systems and reports provide credible and comprehensive information?
 - Are prudent due diligence efforts used in the selection of investment managers when this function is delegated?
 - Does management quickly identify weaknesses and take appropriate action?
 - Have issues noted in audit, compliance or examination reports been resolved?
 - Do policies and procedures address all significant activities?

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12. Interview management and appropriate personnel. Consider discussions that include, at a minimum:
- The trust department's structure and functional responsibilities
 - Strategic plans
 - Resource limitations in implementing security processing and asset management systems
 - New investment product offerings or the discontinuance of products or services
 - How changes in regulations are incorporated into the asset management process
 - How securities are selected and approved

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13. Review the list of approved investments for fiduciary quality and appropriateness.
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The completion of the Level I procedures may provide sufficient information to make a determination that no further examination procedures are necessary. If no determination can be made, proceed to Level II.

Level II

Level II procedures focus on an analysis of trust department documents such as reports and outsourcing contracts. The examiner should complete the appropriate Level II procedures when the completion of the Level I procedures does not reveal adequate information on which to base a conclusion that the trust department meets the examination objectives. Neither the Level I nor the Level II procedures include any significant verification procedures.

1. Determine whether policies and procedures mirror actual practices and investment philosophy. Consider whether:
 - compliance with governing instruments, applicable law and accepted fiduciary principles is ensured;
 - adequate documentation of asset management and investment decisions is ensured;
 - a defined investment philosophy is present;
 - selection, retention and preservation of assets are adequately addressed;
 - suitability of investments with regard to defined risk tolerances as well as the investment review process is addressed; and
 - exception transactions are addressed.
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2. If any unusual concerns or mistakes are noted in the ADV, discuss with management and determine if an amendment is planned.

3. If there is no formal approved list of investments, assess management's selection process. Consider:

- whether the investments have been appropriately approved and the approval is properly documented; and
 - proper investment research has been performed on the securities.
-

4. Review the list of assets or master securities file to determine if unapproved investments are present in discretionary accounts. Determine if management utilizes exception reports.

5. Evaluate monitoring and tracking systems designed to ensure if account reviews conform to 12 CFR §550.200-220.

6. Review and evaluate cash management practices and policies, giving consideration to the following:

- Do policies and procedures outline the process for promptly investing idle income and principal cash, including the use of an effective sweep arrangement?
 - Are sweep vehicles reviewed on a regular basis?
-

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- | | | |
|-------|---|--|
| 7. | Review and evaluate brokerage placement practices for appropriateness and compliance with 12 CFR §550.140(a). | |
| <hr/> | | |
| 8. | Assess management's methodology for accepting and controlling the risks inherent in closely-held assets and nonmarketable assets such as real estate and partnerships. | |
| <hr/> | | |
| 9. | Evaluate policies, procedures and internal controls regarding trade allocation, initial public offerings and private placements. | |
| <hr/> | | |
| 10. | Ensure that proper controls exist over the personal trading and investing activities of trust department investment employees. | |
| <hr/> | | |
| 11. | Assess systems for ensuring adherence to the trust or advisory agreement. | |
| <hr/> | | |
| 12. | Ensure that proper controls are maintained and disclosures made in accordance with OTS TB 76-1, when the savings association pays or receives referral fees. | |
| <hr/> | | |
| 13. | Ensure that the savings association has established proper controls pertaining to soft dollar or other agreements where the savings association or its affiliated broker dealer receives research reports, investment publications or other benefits from the trading activity associated with its trust and asset management accounts. Are the agreements approved by the board or other committee and fall within the Section 28(e) safe harbor established by the SEC? | |
| <hr/> | | |

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14. Evaluate the savings association's policies, procedures and internal controls for ensuring that advertising, promotional programs and performance claims are factual, complete and in keeping with applicable law.

15. If necessary to validate an assertion, finding or concern arising from the completion of the Level I and II procedures, judgmentally select a limited number of accounts for review considering the degree of risk to the institution. Not all types of accounts need to be reviewed to arrive at a well-founded conclusion.

If the examiner cannot rely on the trust and asset management Level I or Level II procedures, or data contained in department records or internal or external audit reports to form a conclusion; Level III procedures may be necessary.

Level III

Level III procedures include verification procedures that auditors usually perform. Although certain situations may require that Level III procedures be completed, it is not the standard practice of Office of Thrift Supervision (OTS) examination staff to duplicate or substitute for the testing performed by auditors.

1. Select a sample of different types of trust and asset management accounts for review selecting those that could pose the highest risk to the savings association. Perform the following:
 - Compare all assets in the accounts to the approved investment list and determine the reasons for the presence of unapproved investments. Inquire about the handling of such assets.
 - Determine if an undue asset concentration of a particular type or security is present within accounts. Inquire if there is a plan to diversify. If diversification is not planned, determine the reasonableness of that decision.

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- Review investment transactions with respect to the accounts and determine if they are appropriate and properly approved.
- Determine that an account investment objective has been assigned and is appropriate considering the characteristics of the account.
- Determine if the investments are in compliance with the governing document and applicable law.
- Determine if all required investment reviews have been performed.

2. Are signed and updated investment objective and acknowledgment letters included in account files? If not, determine how the savings association ensures that the investment officer is aware of the investment objective for the account. Is documentation required?

3. If unapproved assets are noted on the exceptions list, does the client or governing instrument authorize the investments? If not, is management's plan for retention or disposition valid and documented?

4. Review a sample of accounts reviewed by the audit and/or compliance departments and determine if the findings of the audit/compliance review are consistent with examination findings. If not, determine the reasons for any discrepancy.

5. Select a sample of discretionary accounts and determine if all asset reviews are performed when required. If exceptions are noted, determine the reason why.

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6. Evaluate account reviews for sufficient documentation considering synopses of governing instruments, background and needs of beneficiaries, and special reports on real estate, closely held companies and miscellaneous assets.

7. Determine if minute books identify reviewed accounts and contain written conclusions on advisability of retaining or disposing of assets, as well as information and reasons for nonexecution of approved investment actions.

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Examiner's UITRS Rating, Summary, Conclusions and Recommendations:

References - 810P

Laws

ERISA Section 404(a)(1)

Code of Federal Regulations

12 CFR 550.140 Policies and Procedures
12 CFR 550.150(a) Department Managed by Board
12 CFR 550.180 Use of Outside Service Providers
12 CFR 550.200-220 Account Reviews
12 CFR 550.290 Funds Awaiting Investment of Distribution
12 CFR 2550.404(a)(1) Prudent Investing

Office of Thrift Supervision Publications

Other

Workpaper Attachments - 810P

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Portfolio Management Examination Program

Optional Topic Questions

The following list of questions is offered merely as a tool and reference for the examiner and is not a required part of the examination process.

Policies and Procedures

| |
|---|
| • Are policies and procedures adequate for services rendered? |
| • Does the board of directors or appropriate committees approve the policies? |
| • Does the policy outline the overall investment philosophy and standards of practice? |
| • Does the policy outline the expected code of conduct for the employees, officers and directors who have investment responsibilities? |
| • Does the policy outline standard safeguards against conflicts of interest and self-dealing? |
| • Does the policy discuss the process for the use of proprietary or affiliated products in discretionary fiduciary accounts? |
| • Does the policy discuss overall portfolio guidelines regarding percentage distribution among types of investments relative to account objectives? |
| • Does the policy outline the functions and responsibilities of investment personnel, including officers and employees as well as any committees? |
| • Does the policy outline standards and procedures to evaluate and monitor asset quality? |
| • Does the policy outline the process and criteria for selecting and evaluating potential investments? |
| • Does the policy outline the process for monitoring existing investments? |
| • Does the policy outline the documentation requirements to support investment decisions? |
| • Does the policy discuss diversification guidelines and requirements? |
| • Does the policy outline the process for conducting initial and annual account reviews in conformance with the requirements of 12 CFR§550.200 - 220? |
| • Does the policy establish standards for the acceptance and disposition of substandard assets? |
| • Does the policy outline the standards for developing and amending approved lists of investments? |
| • Does the policy address the requirements for authorization and clearance of account overdrafts? |
| • Does the policy establish standards for the selection and use of broker-dealers? |
| • Does the policy outline the process for voting proxies for investments held in fiduciary accounts? |
| • Does the policy outline the process for approving deviations from established policy guidelines, as well as a process for monitoring policy deviations? |

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Audit Program

- | |
|---|
| <ul style="list-style-type: none">• Does the audit program provide adequate coverage of the asset management section? |
| <ul style="list-style-type: none">• Does the audit report address weaknesses in asset management? |
| <ul style="list-style-type: none">• Has corrective action been implemented to correct noted audit deficiencies or weaknesses? |

Investment Delegation

- | |
|---|
| <ul style="list-style-type: none">• Are delegated investment activities permissible under applicable law? |
| <ul style="list-style-type: none">• Is the selection and monitoring process effective? |
| <ul style="list-style-type: none">• Does a policy exist that outlines the delegation decision making process, the investment activities to be outsourced and the criteria for selecting and monitoring third parties? |

Investment Objective

- | |
|--|
| <ul style="list-style-type: none">• Does the investment selection process consider income and liquidity requirements, tax status, beneficiary ages, account termination date, customer preference and other items? |
| <ul style="list-style-type: none">• Does the process provide for an investment action plan to achieve investment goals, including the restructuring and disposition of assets? |
| <ul style="list-style-type: none">• Are changes to strategies or account objectives tracked to ensure implementation? |
| <ul style="list-style-type: none">• Is the development and implementation of specific investment strategies to meet stated investment objectives timely? |
| <ul style="list-style-type: none">• Is the review and monitoring of investment strategies according to policy? |
| <ul style="list-style-type: none">• Do deviations from approved investment strategies require authorization and approval? |

Internal Asset Review

- | |
|---|
| <ul style="list-style-type: none">• Are asset reviews conducted prior to acceptance, initially upon acceptance and annually thereafter? |
| <ul style="list-style-type: none">• Is there a process to ensure that all account circumstances are considered during the review? Items that should be considered in the asset review include asset quality, asset performance, asset mix, diversification, liquidity, etc. |
| <ul style="list-style-type: none">• Do reports exist that identify assets that have not been reviewed or where the review was incomplete? If such reports are used, determine what methods are used to track and monitor delinquent and/or outstanding reviews. |
| <ul style="list-style-type: none">• Does the policy and practice provide for documentation of all asset reviews? |

Brokerage Placement Practices

- | |
|--|
| <ul style="list-style-type: none">• Is there a process for determining the reasonableness of commissions paid in relation to the research services being provided? |
|--|

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- | |
|---|
| <ul style="list-style-type: none">• Does the evaluation of the commissions include a review of the qualifications of the broker-dealer, to include: financial condition; knowledge of the market; access to sources of supply; timely and accurate record keeping; accuracy of services; and quality of research materials. |
| <ul style="list-style-type: none">• Are brokerage placement decisions reviewed periodically by the appropriate oversight committee? |
| <ul style="list-style-type: none">• Is best execution being achieved and do soft dollars received conform to SEC safe harbor provisions? |

Cash Management

- | |
|---|
| <ul style="list-style-type: none">• Does a process for promptly investing idle income and principal cash, including the use of sweep arrangement exist? |
| <ul style="list-style-type: none">• Are effective sweep systems and procedures in place? Do procedures comply with applicable law? |
| <ul style="list-style-type: none">• Are sweep vehicles reviewed for appropriateness on a regular basis? |

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Introduction to Marketable Securities

Marketable securities refer to the securities that are actively traded in recognized markets, where they may be readily valued, purchased or sold. Specifically, marketable securities include common and preferred stocks, U.S. Government securities, corporate bonds, municipal securities, mutual funds and cash management instruments. The relative liquidity of these instruments generally allows the trustee to convert them into cash more readily than other types of investments.

A savings association should thoroughly research and analyze a marketable security prior to making a decision to purchase, retain or sell it. Investment research may be performed internally or be provided by external research firms. There is no requirement that a savings association perform its own research and no prohibition against hiring an external firm to provide investment advice. No matter what method is used, the process should be fully detailed in the trust department's policies and operating procedures and all investment decisions should be supported by research material and analysis. An important aspect of the process is the ability to identify exceptions to the policy. Reasons or corrective action for such exceptions should be fully documented and monitored. Failure to do so will increase the risk profile of the savings association.

As trustee, a savings association may become invested in a large number of individual securities (stocks, bonds, mutual funds etc.). It may be highly inefficient to research and analyze each of these securities. Therefore, many trust departments have developed "approved lists" of securities to facilitate the process of investment management. The use of this list reduces the number of security holdings in discretionary accounts that are not actively followed by asset management personnel. If such lists are used, policies should specify the individuals having authority to make additions or deletions to the list. Appropriate personnel and/or committees should closely monitor the list and any changes resulting from current research should be considered, reviewed and approved. Finally, procedures should exist to monitor actual investment decisions made for compliance with the approved list.

Appropriate personnel should periodically conduct a review of all marketable securities held by fiduciary accounts. The review should consider financial data relevant to both the specific entity and the industry. The records of the savings association must document the reviews performed and the conclusions reached.

Presented below are some of the more commonly accepted advantages relative to the different types of marketable securities, followed by a list of some of the factors which should be considered prior to making an investment decision regarding the use of these securities. While the advantages are discussed separately, one of the most significant advantages is their use together. A portfolio, which is diversified with a mix of securities, will assist in minimizing the risk of large losses and account fluctuations.

Common and Preferred Stocks: The use of common stock in a fiduciary account's investment portfolio offers a number of advantages in terms of meeting investment objectives. One, income from dividend payments may be sufficient to cover a beneficiary's need for current income. Two, capital appreciation could increase the total value of the portfolio for the remainder beneficiaries. Three, for accounts that are not tax-exempt, any capital gains are in most cases taxed at a lower rate than ordinary income. Four, trading stocks on the open market results in easier and more efficient trading compared to other types of investments. Finally, holding stocks allows a portfolio manager to exercise "secondary" or additional investment strategies such as writing covered call options or equity swaps, which may increase the account's yield,

without substantially increasing the risk. The following is a partial list of the factors that should normally be considered in making an investment decision pertaining to common and preferred stocks:

- Quality and depth of company management
- Financial condition of the company, including its position in the industry
- Quality of earnings, both current and historical
- Future prospects, both for the company in terms of competition, growth, sales, etc.
- Impact upon the company of any anticipated legislation or any government, management, or labor activities
- Ability of the company to develop, upgrade and/or market products to expand into new lines of business
- Ratings received by financial rating services
- Opinions rendered by accountants on financial statements
- Impact of any pending or existing litigation

Debt Securities: Debt securities include U.S. Government and agency obligations, corporate bonds and notes and commercial paper. U.S. Government and agency obligations offer advantages of quality, security, stability of income, marketability and elimination of credit and liquidity risk. Corporate obligations offer the advantages of being senior in liquidation of stocks, general stability and regularity of income. In addition, since they are issued with varying maturity dates, their use allows a portfolio manager to ladder maturities to achieve investment goals and reduce interest rate risk. Commercial paper of large corporations provides an alternative to short-term Treasury bills and is often used for investing temporary funds for up to one year. Their advantage is greater when short-term yields are high and uncertainty is present in the market. The following is a partial list of factors to be considered when making decisions regarding investments in debt securities:

- Quality and depth of management
- Capitalization of the company, including consideration of the trend of capital expenditures and nature of the industry
- Issuer's earning power and income projections
- Ability of the issuer to repay
- Rating received from financial rating services
- Rate of interest
- Maturity and yield to maturity
- Present and future marketability of the issue

In addition, special types of debt securities may require consideration of other factors. For example, public utilities will require a consideration of the probability of rate increases, the effect of increased fuel costs and the effects of anticipated changes in demand.

Municipal Securities: The biggest advantage to state and municipal securities has been their exemption from federal income taxes. Beneficiaries in high income tax brackets have found these investments to be attractive. The following is a partial list of the factors to consider in making investment decisions pertaining to municipal securities:

- Sufficiency of actual and anticipated tax revenues to cover present and anticipated debt service
- Power and ability of the taxing authority to levy sufficient taxes to cover the debt service requirements
- Assessed property valuations and their relationship to tax burden
- Projected growth of tax base
- Historical trend of debt
- Budget considerations or constraints of the municipality
- Cash flow requirements
- Accuracy of past estimates of revenues and expenses

As with corporate debt, other special types of municipal securities may require additional considerations.

Marketable Securities Examination Program

Examination Objectives

To determine the adequacy and/or effectiveness of the trust department's administration of marketable securities. Consider whether:

- policies and procedures have been established to ensure compliance with governing instruments, applicable law and accepted fiduciary principles;
- adequate investment policies and monitoring procedures have been established;
- investment research and documentation adequately support investment decisions; and
- deficiencies are identified and corrective action promptly initiated.

Examination Procedures

Wkp. Ref.

Level I

Level I procedures first focus on a review of the examination scoping materials. The next step consists of interviews with trust department personnel to confirm their qualifications and levels of expertise; to determine if the trust department's practices conform to written guidelines; to establish whether any significant changes in personnel, operations or business practices have occurred; or whether new products and/or services have been introduced. If items of concern are uncovered during Level I procedures or if problems are identified during the preexamination monitoring and scoping; the examiner may need to perform particular Level II procedures.

1. Review examination scoping materials related to the selection and monitoring process for marketable securities for the trust department. Scoping material should include:
 - Risk profile
 - Relevant PERK documents
 - Previous trust and asset management examination report
 - Workpapers from the previous examination
 - Previous safety and soundness examination report

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- Board of director and investment committee minutes
 - Most recent ADV
 - Examples of investment research materials utilized
-

2. Evaluate the trust department's policies and procedures related to marketable securities. Note any significant changes. Consider whether they address:

- compliance with governing instruments, applicable law and accepted fiduciary principles;
 - the process and criteria, by which marketable securities are analyzed, selected, evaluated and approved;
 - documentation to support the selection and monitoring process;
 - use of outside firms to provide research and analysis; and
 - how exceptions to policies and procedures are handled.
-

3. Evaluate whether management has the knowledge and expertise to select and monitor marketable securities. Note any significant personnel and/or organizational changes.

4. Review and evaluate the analysis, selection, evaluation and approval process with respect to marketable securities. Give consideration to the following:

- Factors used in evaluating marketable securities
- The documentation maintained to support the evaluation and selection process
- The level of authority required to approve the selection of a marketable security or to remove a security from an approved status

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- The level of monitoring performed on approved securities
-
5. If investment research and analysis is provided by an outside source, review the information obtained and determine:
- How the information is evaluated and used by management
 - If the evaluation process is effective
 - If written agreements are reviewed and if they address all pertinent issues
-
6. Evaluate how information generated from the analysis, selection, evaluation and approval process is communicated to and used by applicable portfolio managers in the administration of trust and asset management accounts.
-
7. Consider whether the following risk contributors (if applicable) have been addressed:
- Does management fully understand all aspects of risk with respect to marketable securities?
 - Are policies and procedures adequate?
 - Is investment research and analysis sound?
 - Does management anticipate and respond well to market and technological changes?
 - Are management information reports comprehensive and credible?
 - Is the internal control environment adequate?
 - Does management satisfactorily review and assess exceptions to policy?
 - Does management quickly identify weaknesses and take appropriate action?

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- Have material issues noted in audit, compliance or examination reports been corrected?
-

The completion of the Level I procedures may provide sufficient information to make a determination that no further examination procedures are necessary. If no determination can be made, proceed to Level II.

Level II

Level II procedures focus on an analysis of trust department documents such as reports and outsourcing contracts. The examiner should complete the appropriate Level II procedures when the completion of the Level I procedures does not reveal adequate information on which to base a conclusion that the trust department meets the examination objectives. Neither the Level I nor the Level II procedures include any significant verification.

1. If there are unresolved exceptions noted on internal or external audit, compliance or examination reports determine and evaluate the reasons for their presence. Evaluate management's plan to correct the exceptions.

2. Review and verify the accuracy of any applicable management exception reports.

3. Review management reports describing additions or deletions from the approved marketable securities list. Evaluate the reasons for additions or deletions to the list and who has the authorization approval. If management does not use an approved marketable securities list, determine how it monitors the addition/deletion of marketable securities and evaluate the effectiveness of this process.

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4. Review the composition and quality of marketable securities in trust and asset management accounts. Note any changes from the previous examination in the number or type of securities. Consider:
- the reasons for the change in asset composition and whether management planned for this change; and
 - whether a risk assessment was factored into this change and if not, determine the reasons why it was not.

5. Has the trust department purchased over five percent of a particular stock compared to the total stock outstanding for a company and is the holding supported?

6. Are there any unusual concentrations of any one security in an account where the trust department exercises discretion?

7. Are the investment policies sufficient to include the disposal of unsuitable assets delivered in kind and restructuring of the portfolio within a reasonable period of time?

8. If necessary to validate an assertion, finding or concern arising from the completion of the Level I and II procedures, judgmentally select a limited number of accounts for review considering the degree of risk to the institution. Not all types of accounts need to be reviewed to arrive at a well-founded conclusion.

If the examiner cannot rely on the data contained in the trust and asset management Level I or Level II procedures, or data contained in department records or internal or external audit reports; proceed to Level III.

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Level III

Level III procedures include verification procedures that auditors usually perform. Although certain situations may require that Level III procedures be completed, it is not the standard practice of Office of Thrift Supervision (OTS) examination staff to duplicate or substitute for the testing performed by auditors.

1. Select a sample of discretionary accounts containing unapproved or nonrated securities to determine that proper authorization for the securities is present, such as a recent direction letter. If proper authorization is not present, what is the process for reducing the securities presence?

2. Pull a sample of discretionary accounts and review these accounts to determine whether there is evidence of excessive trading (churning) within the account. Consider:
 - the number and frequency of trades;
 - the amount of commissions generated;
 - the account's investment objectives relative to the assets traded;
 - the degree of control the savings association or a broker has over an account;
 - the appropriateness of trades between accounts, if applicable; and
 - whether the quality of the account portfolio was downgraded as a result of the trading activity.

3. Select a sample of accounts containing marketable securities that were reviewed by the audit and/or compliance functions. Determine if the findings of the audit/compliance review are consistent with examination findings.

4. Review the approved marketable securities list and select a sample of securities to review. Include common and preferred stocks, corporate bonds, municipal securities, mutual funds

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(unless reviewed under program 830) and cash management instruments. Consider:

- The supporting research and analysis and assess whether the research and analysis is adequate to support management's decision.
 - The research and analysis performed conforms to policies and procedures and appropriate documentation is retained.
 - Whether appropriate internal approvals were obtained to include the security on the approved list.
-

5. Review the master list of marketable securities and determine if any unapproved securities are present. Select a sample of securities to review. Consider:

- Whether unapproved securities are included on management's exception report. If unapproved securities are not on the exception report, determine the reason for this lapse and how management monitors unapproved marketable securities.
 - Whether there is a retention process and the reasons for retention are well documented.
-

6. Select a sample of discretionary accounts with investments in marketable securities. Evaluate the following:

- Are the marketable securities in the account on the approved list? If not, determine the reasons, assure appropriate internal approvals were obtained and verify that it is on the exception report.
 - Are the marketable securities in the account appropriate in view of the investment objective of the account, characteristics and risk tolerances of the beneficiaries, the type of account and other pertinent factors?
-

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Examiner's UITRS Rating, Summary, Conclusions and Recommendations:

References - 820P

Laws

Investment Advisors Act of 1940
Investment Company Act of 1940

Code of Federal Regulations

| | |
|----------------|---------------------------------------|
| 12 CFR 550.140 | Policies and Procedures |
| 12 CFR 550.240 | Trust Powers (General) |
| 12 CFR 550.260 | Investment of Funds Held as Fiduciary |

Office of Thrift Supervision Publications

| | |
|---------|---|
| TB 76-2 | Conflicts of Interest Related to Fiduciary Accounts |
|---------|---|

Other

Scott on Trusts, 3rd Ed.
Bogert and Bogert, Trust and Trustees, 2nd Ed.
Restatement (Second and Third) of Trusts

Workpaper Attachments - 820P

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Marketable Securities Examination Program

Optional Topic Questions

The following list of questions is offered merely as a tool and reference for the examiner and is not a required part of the examination process.

Policies and Procedures

| |
|--|
| <ul style="list-style-type: none">• Are the policies adequate to properly administer marketable securities? |
| <ul style="list-style-type: none">• Do the policies consider quality and depth of management when evaluating a security? |
| <ul style="list-style-type: none">• Do the policies require a comparison of investment performance to applicable benchmarks? |
| <ul style="list-style-type: none">• Are the following factors considered when investing in publicly traded companies?<ul style="list-style-type: none">• Financial condition and position of the company in the industry?• The quality of earnings and historical growth of the company?• The future prospects of the company, projected earnings and competition?• The anticipated availability of raw materials and employee resources to sustain the company's future growth?• The potential impact of anticipated legislation and possible government intervention?• The ability of the company to develop new products and/or upgrade existing products? |
| <ul style="list-style-type: none">• Does management require the following factors to be assessed before investing in publicly traded companies?<ul style="list-style-type: none">• The liquidity of the market issuer?• The potential litigation pending against the issuer?• The ability of the borrower to repay debt?• Ratings assigned by third party providers?• Trends in capital expenditures? |

Investment Decisions

| |
|--|
| <ul style="list-style-type: none">• Are decisions based on adequate research and analysis (whether performed in-house or acquired from outside sources), including an evaluation of relevant factors pertaining to the type of security under consideration? |
| <ul style="list-style-type: none">• Are decisions based on an evaluation of relevant factors pertaining to the type and characteristics of the account for which the decision is being made? |
| <ul style="list-style-type: none">• Are decisions adequately supported and well documented? |

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Discretionary Accounts

| |
|---|
| <ul style="list-style-type: none">• Are at least one of the ratings agencies utilized, such as Standard and Poor or Moodys decisions? |
| <ul style="list-style-type: none">• Does management periodically review sources of investment research to determine the quality of research provided? |
| <ul style="list-style-type: none">• Does management review research material, to determine if adequate justification exists to support investment decisions, including information relating to the company's management and financial condition, such as, balance sheets, annual report, and position in the industry? |
| <ul style="list-style-type: none">• For securities not rated, or whose ratings do not conform to stated guidelines, does management review to determine if sufficient justification exists for holding the security? Justification might include, for example, an investment decision based on independent research and supported by a thorough analysis or holding the security to defer tax loss. |

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Introduction to Mutual Funds

The biggest advantage to investing in mutual funds is the ability to readily achieve a diversified portfolio to meet investment objectives. A diversified portfolio helps reduce risk by offsetting losses from some securities with gains in others. There are four basic types of mutual funds: stock (equity), bond, hybrid and money market. Money market funds are referred to as short-term funds because they invest in securities that generally mature in one year or less, while stock, bond and hybrid funds are known as long-term funds. An investor in a mutual fund is a shareholder who owns shares of the fund. A share is typically represented by its net asset value (NAV). Each share represents proportionate ownership in all of the fund's underlying securities. The securities are selected by a professional investment adviser to match the fund's objectives as described in the prospectus. Below is a partial listing of factors to consider when making investment decisions regarding the use of mutual funds:

- Quality and experience of investment company management, specifically the fund manager
- Risk adjusted rates of return for the fund and their consistency over various time periods and comparisons to other related funds (benchmarks)
- Compliance with the investment style of the fund as described in the prospectus ("style drift")
- Quality of existing holdings
- Tax efficiency of the fund
- Mutual fund fee structure

Proprietary Mutual Funds

A proprietary mutual fund is a fund that the thrift or thrift affiliate acts as an investment adviser. When acting as a discretionary trustee, the savings association should determine whether applicable law would allow the purchase of shares of a proprietary mutual fund as such a purchase would be a conflict of interest. Many states have adopted statutes that would permit the purchase of shares of a proprietary mutual fund for a discretionary fiduciary account. The statutes are very different in regards to fees that may be charged, disclosures and consent. Savings associations should make sure that they are carefully following every aspect of the appropriate state statute. Even if there is a state statute that permits purchases of proprietary mutual fund shares for discretionary fiduciary accounts, a savings association must determine whether such an investment meets the prudence requirements of the applicable state law. The prudence analysis should be documented and available for review by examiners. The savings association should provide beneficiaries who are entitled under state law to receive account statements a copy of the mutual fund's prospectus. It is good risk management practice to also provide disclosure of the affiliated relationships, the nature of the services provided and the amount of fees paid to the savings association, its subsidiaries or affiliates.

If the savings association is acting as a trustee or other fiduciary for employee benefit accounts, it should be fully aware of all the ERISA restrictions regarding such conflict of interest transactions and meet any applicable Department of Labor (DOL) guidelines. The DOL has issued a prohibited transaction class exemption (PTE 77-4) that permits the investment of employee benefit accounts for which a savings association is a fiduciary in a proprietary mutual fund, provided certain conditions are met. The DOL has

also issued several advisory opinion letters (93-12A and 93-13A) that address secondary services provide by a bank to a proprietary mutual fund without a waiver or credit of fees.

Mutual Fund Fee Structure

Mutual funds have certain costs of operating. Costs are important because they lower the return of the fund. A fund that has a sales load and high expenses will have to perform better than a low-cost fund just to stay even with the low-cost fund. Information regarding the costs to the fund can be located in the fee table near the front of the fund's prospectus. The fee table can be used to compare the costs of different funds. The fee table breaks costs into two main categories: 1) sales loads and transaction fees (paid when a fund share is bought, sold or exchanged) and 2) ongoing expenses (paid periodically during the investment in the fund).

Sales Loads: The first part of the fee table will indicate if the fund charges any sales loads. No-load funds do not charge sales loads. There are no-load funds in every major fund category. Even no-load funds have ongoing expenses, however, such as management fees. When a mutual fund charges a sales load, it usually pays for commissions to people who sell the fund's shares, as well as other marketing costs. A front-end load is a sales charge that is paid when shares are bought. This type of load, by law, cannot be higher than 8.5 percent. An example of a front-end load would be where an investor has \$1,000 to invest in a mutual fund with a 5 percent front-end load, \$50 will go to pay the sales charge and \$950 will be invested in the fund. A back-end load (also called a deferred load) is a sales charge that is paid when shares in the fund are sold. It usually starts out at 5 or 6 percent for the first year and gets smaller each year after that until it reaches zero (say, in year six or seven of the investment). An example of a back-end load would be where an investor has \$1,000 invested in a mutual fund with a 6 percent back-end load that decreases to zero in the seventh year. Assume for purposes of this example that the value of the investment remains at \$1,000 for seven years. If the shares were sold during the first year, the investor would receive \$940 (ignoring any gains or losses). \$60 would go to pay the sales charge. If shares were sold during the seventh year, the investor would receive back \$1,000.

Ongoing expenses: The second part of the fee table indicates the kinds of ongoing expenses that will be paid while remaining invested in the fund. The table shows expenses as a percentage of the fund's assets, generally for the most recent fiscal year. High expenses do not assure superior performance. Higher expense funds do not, on average, perform better than lower expense funds. But there may be circumstances in which it is appropriate to pay higher expenses. For example, higher expenses will be incurred for certain types of funds that require extra work by its managers, such as international stock funds, which require sophisticated research. Higher expenses may also be paid for funds that provide special services, like toll-free telephone numbers, check-writing and automatic investment programs. A difference in expenses that may look small can make a big difference in the value of the investment in the fund over time. An example of this would be where an investor has \$1,000 invested in a fund. Assume for purposes of this example that the investor receives a flat rate of return of 5 percent before expenses. If the fund has expenses of 1.5 percent after 20 years, the investor would end up with roughly \$1,990. If the fund has expenses of 0.5%, the investor would end up with more than \$2,410. This is a 22 percent difference.

One type of ongoing fee that is taken out of fund assets has come to be known as a rule 12b-1 fee. It most often is used to pay commissions to brokers and other salespersons and occasionally to pay for advertising and other costs of promoting the fund to investors. It usually is between 0.25 percent and 1.00 percent of assets annually. A rule implemented in 1993 effectively capped 12b-1 fees at 0.75 percent but this rule also permitted "administrative service fees" of an additional 0.25 percent per year. Funds with back-end loads usually have higher rule 12b-1 fees.

A savings association should document carefully its reasons for choosing particular mutual funds as investment vehicles for discretionary accounts. These reasons could include the specific characteristics of a unique investment style or that the investment return supports increased fees. If the institution does not adequately support its decision making process, it may be subject to questionable prudent investment practices.

Mutual Funds Examination Program

Examination Objectives

To assess the level and quality of oversight of the trust department's selection and monitoring of mutual funds. Consider whether:

- effective policies, procedures and internal controls for the selection and monitoring of mutual funds have been established;
- compliance with governing instruments, applicable law and accepted fiduciary principles is ensured;
- documentation to support investment decisions is maintained; and
- corrective action is taken when violations of governing instruments, applicable law or accepted fiduciary principles occur.

Examination Procedures

Wkp. Ref.

Level I

Level I procedures first focus on a review of the examination scoping materials. The next step consists of interviews with trust department personnel to confirm their qualifications and levels of expertise; to determine if the trust department's practices conform to written guidelines; to establish whether any significant changes in personnel, operations or business practices have occurred; or whether new products and/or services have been introduced. If items of concern are uncovered during a Level I procedure or if problems are identified during the preexamination monitoring and scoping, the examiner may need to perform certain Level II procedures.

1. Review examination scoping materials related to mutual fund selection and monitoring. Scoping material should include:
 - Risk profile
 - Relevant PERK documents
 - Previous trust and asset management examination report
 - Work papers from the previous examination
 - Board of director and other appropriate committee minutes

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- Examination reports of subordinate, functionally regulated entities
- Savings association's web page
- Recent ADV and any amendments

2. Evaluate the trust department's policies and procedures concerning the selection and monitoring of mutual funds as investments for trust and asset management accounts. Consider:

- How compliance with applicable law, standards of fiduciary conduct and policies and procedures are ensured.
- The process and criteria used to select and monitor mutual funds as investments for discretionary accounts, including the use of outside firms to provide research and analysis.
- The process used to determine that proprietary mutual funds and mutual funds in which the savings association or its affiliate receives an economic benefit, meet the appropriate prudent investment state law standards.
- The process used to determine that proprietary mutual funds and mutual funds, in which the savings association or its affiliate receives an economic benefit, address the conflict of interest inherent in such an investment. This includes a determination of the appropriate state statute permitting such an investment, if applicable, and a system for determining that all state statute requirements have been met.

3. Evaluate whether management has the knowledge and expertise necessary to formulate and carry out mutual fund investment policies and procedures. Note any significant personnel and/or organizational changes.

4. Review and evaluate the analysis, selection and approval process with respect to mutual funds.

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-
5. If investment research and analysis is obtained from an outside source, evaluate the quality and timeliness of information obtained.
-
6. Determine and evaluate how information generated from the analysis, selection and approval process is communicated to and used by staff involved in the administration of trust accounts.
-
7. If there are unresolved exceptions present from internal or external audit reports, compliance reports or examination reports, determine the reasons for their presence. Evaluate management's plan to correct these exceptions.
-
8. Consider whether the following risk contributors (if applicable) have been addressed:
- Does management fully understand all aspects of risk with respect to mutual fund investments?
 - Are policies and procedures adequate?
 - Does management anticipate and respond well to market and technological changes?
 - Is investment research and analysis sound?
 - Are management information reports comprehensive and credible?
 - Is the internal control environment adequate?
 - Does management satisfactorily review and assess exceptions to policy?
 - Does management monitor fund analysts for adverse comments on mutual funds held by discretionary accounts?

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- Does management quickly identify weaknesses and take appropriate action?
 - Are there material unresolved mutual fund issues noted in audit, compliance or examination reports?
-

Level II

Level II procedures focus on an analysis of trust department documents such as reports and outsourcing contracts. The examiner should complete the appropriate Level II procedures when the completion of the Level I procedures does not reveal adequate information on which to base a conclusion that the trust department meets the examination objectives. Neither the Level I nor the Level II procedures include any significant verification procedures.

1. If changes in the amount, type or quality of mutual funds in discretionary accounts since the previous examination result in a change in the savings association's risk profile, determine:
 - the reasons for the change;
 - if management's risk assessment considered this change; and
 - if not, determine the reasons why it was not considered.

2. Review management reports describing additions or deletions from the approved mutual fund list. Evaluate the reasons for additions or deletions to the list.

3. If proprietary mutual funds are used as investments for discretionary accounts, determine that procedures are in place to monitor compliance with OTS TB 76-2. Confirm that:
 - a copy of the mutual fund prospectus is provided to interested parties;
 - there is adequate documentation in the account file showing that the mutual funds are

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prudent investments for the account;

- appropriate disclosures are made regarding the affiliate relationship, the nature of services provided and the amount of fees paid to an affiliate; and
- discretionary accounts are being invested in the appropriate class of the mutual fund, e.g. an institutional class vs. a retail class.

4. If investment authority has been delegated to an affiliate or third party that invests in proprietary mutual funds of the affiliate or third party, determine that management conducts an appropriate review of the activity to ensure that actions taken by the affiliate or third party meet OTS TB 76-2 regarding conflicts of interest and prudent investment of discretionary accounts.

5. If management does not produce an exception report, determine how it monitors unapproved mutual funds and conclude if this process is reasonable and effective.

6. If proprietary mutual funds are present in discretionary accounts, review management reports comparing the performance of the funds to benchmarks. Evaluate the benchmarks being used to compare the performance of the proprietary funds.

7. If there has been a conversion of a savings association's common and/or collective investment funds into the savings association's proprietary mutual funds, coordinate with the examiner performing the common/collective investment funds program, and determine whether the savings association considered all applicable law requirements as well as fiduciary principles before the conversion occurred.

8. Review and verify the accuracy of any applicable management information or exception reports.

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9. Determine how proxies for proprietary mutual fund shares are voted when held by discretionary accounts. Is there a process in place for voting these proxies in the best interests of the accounts invested in the proprietary funds?

10. If necessary to validate an assertion, finding or concern arising from the completion of the Level I and II procedures, judgmentally select a limited number of accounts for review considering the degree of risk to the institution. Not all types of accounts need to be reviewed to arrive at a well-founded conclusion.

If the examiner cannot rely on the trust and asset management Level I or Level II procedures, or data contained in department records or internal or external audit reports to form a conclusion, proceed to Level III.

Level III

Level III procedures include verification procedures that auditors usually perform. Although certain situations may require that Level III procedures be completed, it is not the standard practice of Office of Thrift Supervision (OTS) examination staff to duplicate or substitute for the testing performed by auditors.

1. Pull a sample of discretionary accounts and determine if “load” mutual funds are used. Determine whether the use of “load” funds are prudent by comparing the performance of “load” mutual fund to mutual funds that have no sale charges or “loads.”

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2. Pull a sample of discretionary accounts and review them to determine whether funds that have approved a 12b-1 fee arrangement are an appropriate investment for the account. When reviewing employee benefit accounts determine if the Department of Labor guidelines are being followed.

3. Select a sample of discretionary accounts and review their mutual fund investments. Include in the sample those accounts invested in proprietary mutual funds as well as funds in which the savings association or its affiliate is receiving an economic benefit. Determine if the mutual funds in the account are appropriate in view of the investment objectives of the account, characteristics and risk tolerances of the beneficiaries, the type of account and other pertinent factors.

4. Select a sample of discretionary accounts with investments in mutual funds. Consider whether the mutual funds in the account are appropriate in view of the investment objective of the account, characteristics and risk tolerances of the beneficiaries, the type of account and other pertinent factors.

5. Review the mutual funds held in discretionary accounts and compare them to the approved mutual fund list. If any unapproved funds are present, select a sample of those funds to review. Consider:

- Whether unapproved mutual funds are included on the exception reports.
- The reasons for the unapproved mutual funds and whether the exception has been approved and properly documented. If the unapproved mutual fund is not on the exception report, determine the reason for this lapse and assess the appropriateness of the investment.

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6. Select a sample of discretionary accounts containing mutual funds reviewed by the audit and/or compliance functions. Determine if the findings of the audit/compliance review are consistent with examination findings.

7. Select a sample of nondiscretionary accounts containing mutual fund investments to determine that proper authorization for the mutual fund is present, such as a current direction letter.

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Optional Topic Questions

The following list of questions is offered merely as a tool and reference for the examiner and is not a required part of the examination process.

Policies and Procedures

| |
|---|
| <ul style="list-style-type: none">• Are policies and procedures adequately documented? |
| <ul style="list-style-type: none">• Are the policies developed and approved by the board of directors or an appropriate committee of the board? |
| <ul style="list-style-type: none">• Do the policies outline standards to safeguard against conflicts of interest and self-dealing? |
| <ul style="list-style-type: none">• Do the policies discuss the process for use of proprietary mutual funds for discretionary accounts? |
| <ul style="list-style-type: none">• Do the policies establish standards and procedures to evaluate and monitor mutual fund quality? |
| <ul style="list-style-type: none">• Do the policies outline the process and criteria for selecting and evaluating potential mutual funds? |
| <ul style="list-style-type: none">• Do the policies outline the process for monitoring existing mutual funds? |
| <ul style="list-style-type: none">• Do the policies outline the standards for developing and amending approved lists of mutual funds? |
| <ul style="list-style-type: none">• Do the policies outline the process for approving deviations from established policy guidelines, as well as a process for monitoring policy deviations? |

Delegation of Investment Responsibility

| |
|---|
| <ul style="list-style-type: none">• Are the delegated investment activities permissible under applicable law? |
| <ul style="list-style-type: none">• Is there a written agreement that addresses all pertinent issues? |
| <ul style="list-style-type: none">• Was the decision to delegate made in accordance with policy? |
| <ul style="list-style-type: none">• Is the selection and monitoring process effective? |
| <ul style="list-style-type: none">• Does a policy exist that outlines the delegation decision making process, the investment activities to be outsourced and the criteria for selecting and monitoring third parties? |

Investment Decisions

| |
|---|
| <ul style="list-style-type: none">• Are decisions based on adequate research and analysis (whether performed in-house or acquired from external sources), including an evaluation of relevant factors pertaining to the type of security under consideration? |
| <ul style="list-style-type: none">• Are decisions based on an evaluation of relevant factors pertaining to the type and characteristics of the account for which the decision is being made? |
| <ul style="list-style-type: none">• In making decisions regarding mutual fund investments, does management consider:<ul style="list-style-type: none">• Quality of investment company management, specifically the fund manager;• Risk adjusted rates of return for the fund and their consistency over various time periods and |

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| |
|---|
| comparisons to other related funds (benchmarks); |
| <ul style="list-style-type: none">• Compliance with prospectus guidelines including diversification and compatibility with funds objectives (“style drift”);• Quality of existing holdings;• Tax efficiency of the fund; and• Mutual fund fee structure. |
| <ul style="list-style-type: none">• Are decisions adequately supported and well documented? |

Investment Research

| |
|--|
| <ul style="list-style-type: none">• Does management investment analysis include one of the ratings agencies, such as Morningstar, Lipper or Value Line to assist in the mutual fund selection decision? |
| <ul style="list-style-type: none">• Does management periodically review sources of investment research, to determine the quality of research provided? |
| <ul style="list-style-type: none">• Does management review research material, to determine if adequate justification exists to support investment decisions, including information relating to the company's management and financial condition, such as balance sheets, annual report and position in the industry? |

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Introduction to Closely-Held Business Interests

For purposes of this section, a closely-held business can be defined as one in which ownership of a business is concentrated in the hands of only a few shareholders and in which there is no publicly traded market for the shares. A principal characteristic of closely-held business interests is that ownership and management is often the same person. Closely-held business interests held in fiduciary accounts most often include closely-held corporations but may also include sole proprietorships and joint venture arrangements. In most instances, these assets are used to fund the trust and are not purchased by the savings association acting in a fiduciary capacity. The governing instrument should have specific language regarding the trustee's responsibilities and powers for such assets.

There are a number of complex issues associated with the administration of closely-held business interests. The savings association must be guided by well-developed policies and procedures to ensure sound and prudent administration and to safeguard against exposure to potential liability. The savings association must also have sufficient skills, either internally or through external arrangements, to properly administer these assets. Any losses resulting from improper administration of the closely-held business will be the responsibility of the savings association.

Managing a closely-held business interest can present a number of problems, not the least of which is acquiring detailed knowledge about the business interest. Regardless of whether the savings association owns a majority or a minority interest, the time necessary to actually manage or be involved in the management is often quite extensive. Shared responsibilities with cofiduciaries also present problems to the trustee. While cofiduciaries can be both cooperative and knowledgeable concerning the business interest, others may be neither.

The savings association, as a discretionary trustee, may need to make decisions regarding the disposition of the closely-held business interest. In those instances where an interest in a closely-held business is used to fund the trust and the governing instrument is silent regarding the disposition of the asset, the trustee must analyze the business interest and determine, in the best interest of the account, whether to continue to operate the business interest or to dispose of it by sale or liquidation. The following items should be considered in the analysis:

- Financial condition
- Management
- Earnings
- Growth
- Marketability
- Product lines and services
- Competition

The savings association and its board of directors are exposed to potential liability when the institution, acting as fiduciary, undertakes the administration of closely-held business interests. In addition to the

concerns listed above, the savings association must always deal with closely-held business interests at arm's length to avoid any conflict of interest or self-dealing transactions.

One way to manage the closely-held business interest, if policy permits, is to have an employee of the savings association (officer) serve as an officer or director of the closely-held business interest. However, this involves a certain degree of potential liability to the savings association and to the employee/officer. Therefore, consideration should be given to obtaining indemnity insurance for these situations.

Closely-Held Business Interests Examination Program

Examination Objectives

To determine the adequacy and/or effectiveness of the trust department's administration of closely-held business interests. Consider whether:

- policies and procedures regarding acceptance and administration for closely-held business interests have been established;
- the scope and nature of responsibilities in connection with closely-held business interests have been identified;
- there is expertise available for administering closely-held business interests;
- policies and procedures are in place to ensure compliance with governing instruments, applicable law and accepted fiduciary principles; and
- deficiencies are identified and corrective action is promptly initiated.

Examination Procedures

Wkp. Ref.

Level I

Level I procedures first focus on a review of the examination scoping materials. The next step consists of interviews with trust department personnel to confirm their qualifications and levels of expertise; to determine if the trust department's practices conform to written guidelines; to establish whether any significant changes in personnel, operations or business practices have occurred; or whether new products and/or services have been introduced. If items of concern are uncovered during Level I procedures or if problems are identified during the preexamination monitoring and scoping, the examiner may need to perform particular Level II procedures.

1. Review examination scoping materials related to closely-held business interests. Scoping material should include:
 - Risk profile
 - Relevant PERK documents
 - Previous trust and asset management examination report

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- Workpapers from the previous examination
- Policies and procedures for closely-held business interests
- Board and committee minutes

2. Review and evaluate policies and procedures pertaining to the acceptance and administration of closely-held business interests.

3. Review the qualifications of management, personnel or third party agents responsible for the administration of closely-held business interests. Observe any changes in personnel, which have occurred during the review period. Evaluate the adequacy of expertise available. If existing staff does not have the expertise to manage the business interests, is there a prudent selection process for hiring outside agents?

4. Is documentation of the history and the nature of the business interests part of the account acceptance process?

5. Prior to accepting an account that is funded by a closely-held business interest, is a review process performed to determine the current condition of the business, such as contingent liabilities and expenses that must be incurred in order to run the business properly?

6. Consider whether the following risk contributors (if applicable) have been addressed:

- the sufficiency of policies, procedures and internal controls;
- the adequacy of management expertise in administering closely-held business activities;

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- the thoroughness of internal audit and compliance;
 - the effectiveness of management supervision; and
 - the reliability and timeliness of management reports.
-

The completion of Level I procedures may provide sufficient information to make a determination that no further examination procedures are necessary. If no determination can be made, proceed to Level II.

Level II

Level II procedures focus on an analysis of trust department documents, such as reports and outsourcing contracts. The examiner should complete the appropriate Level II procedures when the completion of Level I procedures does not reveal adequate information on which to base a conclusion that the trust department meets the examination objectives. Neither the Level I nor the Level II procedures include any significant verification procedures.

1. Review the trust department's list of holdings of closely-held business interests.
-

2. Review the complexity of the businesses and the abilities of the trustee to exercise its responsibilities. What are the reasons for the continued existence of the business, e.g. income, employment, sentimental reasons?
-

3. Review the types of assets of the businesses and any special considerations regarding liability (e.g. environmental liability, personal injury or hazard liability). Are there any prior violations of laws or regulations?
-

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4. Review the level of family intervention regarding decisions made in the business. Consider whether such intervention increases the savings association's liability and/or risk and if so, what actions has management taken to address this situation.

5. Review the level of compensation the savings association receives for the services it renders and liabilities it assumes.

6. Inquire whether there are any potential conflicts with the commercial lending side of the savings association.

7. If necessary to validate an assertion, finding or concern arising from the completion of the Level I and II procedures, judgmentally select a limited number of accounts for review considering the degree of risk to the institution. Not all types of accounts need to be reviewed to arrive at a well-founded conclusion.

If the examiner cannot rely on the trust and asset management Level I or Level II procedures or data contained in department records or internal or external audit reports to form a conclusion; proceed to Level III.

Level III

Level III procedures include verification procedures that auditors usually perform. Although certain situations may require that Level III procedures be completed, it is not the standard practice of the Office of Thrift Supervision (OTS) examination staff to duplicate or substitute for the testing performed by auditors.

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1. Review the trust department's list of holdings of closely-held business interests. Identify those interests that have been added to discretionary accounts since the previous review. Determine if sufficient documentation is on file to support the trust department's decision to accept, purchase, retain or sell the business interest, including:
 - proper authorization for the purchase, retention or sale of any interest, either in the governing instrument, through specific authorization or direction from appropriate parties;
 - the trust department's operational, management or administrative duties;
 - financial information on the company, including annual financial statements, and comparative information on the industry in which the business operates;
 - information related to the review of the business' financial condition and the results of operation; and
 - information related to the business' operation, including a review of corporate structure, management quality, capitalization, operational risks, potential legal liabilities, etc.

2. Select a sample of accounts for review, and determine whether investments in closely-held business interests are of trust quality, suitable as investments for the affected accounts and consistent with the needs and objectives of the accounts. Determine whether the trust department has met its fiduciary responsibility in the operation of the business interest.

3. Review a sample of dispositions/liquidations of closely-held business interests. Evaluate whether the decision to dispose of or liquidate the business was consistent with the account objectives. Review management's efforts to maximize the value of the investment.

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4. For interests held in directed accounts, determine that proper authorization exists, such as a recent direction letter and whether the direction came from a party authorized to make investment decisions.

5. Determine if any business relationships exist between the business interest and the savings association (i.e., lending or depository relationships, use of other services provided by the savings association, etc.). Review these relationships for propriety.

Examiner's UITRS Rating, Summary, Conclusions and Recommendations:

References - 840P

Laws

Code of Federal Regulations

Office of Thrift Supervision Publications

TB 76-2

Conflicts of Interest Relating to Fiduciary Activities

Other

Workpaper Attachments - 840P

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Closely-Held Business Interests Examination Program

Optional Topic Questions

The following list of questions is offered merely as a tool and reference for the examiner and is not a required part of the examination process.

Policies and Procedures

| |
|---|
| <ul style="list-style-type: none">• Does the policy include criteria for the purchase, sale and retention of interests in closely-held businesses? |
| <ul style="list-style-type: none">• Are procedures set forth for monitoring any transactions between the savings association (including its employees and affiliates), trust department and the business? |
| <ul style="list-style-type: none">• Are circumstances described where attending stockholders' meetings of companies is required or desirable (i.e., those relating to management)? |
| <ul style="list-style-type: none">• Are policies for the representation by trust department officers on the boards of companies set forth? |
| <ul style="list-style-type: none">• Does the policy address the extent of control to be exercised over the management of companies in which the trust department has sole or majority voting control, as well as other proxy voting responsibilities? |
| <ul style="list-style-type: none">• Do the policies consider circumstances where the company should be sold as a going concern vs. continued retention? |

Management Qualifications

| |
|---|
| <ul style="list-style-type: none">• Does management have appropriate training or experience in operating closely-held business interests? |
| <ul style="list-style-type: none">• Does management have knowledge and experience in the industry in which the business operates? |
| <ul style="list-style-type: none">• For outside agents, are the qualifications of the agent thoroughly reviewed? |
| <ul style="list-style-type: none">• Does a detailed, written agreement exist between the trust department and the agent? |
| <ul style="list-style-type: none">• Are the fees paid to outside agents commensurate with the requirements of the agreement? |

Documentation

| |
|---|
| <ul style="list-style-type: none">• Is there proper authorization for purchasing or retaining any closely-held interest, either in the governing instrument or other specific authorizations? |
| <ul style="list-style-type: none">• Is there adequate financial and/or other information regarding the market in which the closely-held companies operate? |
| <ul style="list-style-type: none">• Is information reviewed, at least annually, of the company's financial condition and results of operations? |
| <ul style="list-style-type: none">• Are audit report results reviewed? |
| <ul style="list-style-type: none">• Is other information that may be relevant maintained, such as insurance coverage or partnership agreements? |

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Disposition/Liquidation

| |
|--|
| <ul style="list-style-type: none">• Is the decision to dispose of or liquidate the business interest properly authorized by the governing instrument? |
| <ul style="list-style-type: none">• Has management thoroughly analyzed the propriety of disposition or liquidation and is the decision consistent with the account objectives? |
| <ul style="list-style-type: none">• Have appropriate valuation techniques been utilized to set sale prices? |
| <ul style="list-style-type: none">• Has management taken steps to maximize the value of the business interest? |

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Introduction to Real Estate Interests

This section will cover two types of interests: real estate and real estate loans. While holdings of these assets do not typically constitute a large percentage of total account holdings, their specialized nature and often complex characteristics make them deserving of special attention. In order to properly administer real estate interests, the savings association must have specialized and expert knowledge and must pay particular attention to operational and administrative duties. These requirements should be carefully considered prior to making any decision to retain or purchase real estate interests.

Real Estate

Various types of real estate can be held in fiduciary accounts, including personal residences, residential income properties, commercial properties, unimproved acreage, vacant lots, timberland, farm or ranch land. Management should be familiar with all aspects of real property administration, including purchasing, leasing, improving and repairing before undertaking the administration of significant holdings. Due to the variety and complexity of these assets, the savings association should have policies and procedures addressing real estate interests. There are several basic steps that should be followed to assist in minimizing any potential problems that can arise in connection with the administration of real estate. These steps are outlined below:

- The savings association should ensure that it possesses valid and clear title to any property held, whether received in kind or purchased. The best time to remedy defects in the title is when the interest is being acquired. Defects in title can delay a proposed sale and possibly defeat the transaction.
- The savings association should have a program of appraisal and periodic inspection of all real estate held in accounts where it has investment responsibility.
- The savings association should ensure that purchase or retention of real estate is appropriate for meeting the account objectives.
- There should be an effective process for the administration of real estate. Such a process would ensure that adequate insurance is kept current, property taxes are accurate and paid when due and that special requirements are monitored, such as collecting rents, inspecting crops or conducting repairs.

In all but a few states a fiduciary is prohibited from holding title to real estate unless it is qualified to do business in that state. In those cases, a fiduciary holding real estate in an account should appoint an ancillary fiduciary or agent to administer the property. Therefore, the department should have procedures to address any local law requirements in other jurisdictions regarding title to and management of real estate with an out-of-state location.

The savings association should have a program of appraisal and inspection of all real estate held in accounts where it has investment responsibility. It is an accepted fiduciary principle that the fiduciary should possess current information as to the value and condition of properties for which it is responsible. This information is needed in order to make an informed purchase, sale or retention decision. Prudent investment policy would dictate that appraisals and inspections be performed prior to or promptly after acceptance of real estate, and prior to any purchase. Thereafter, appraisals should be made at least every three years for properties held in personal trust accounts. Properties held in employee benefit accounts should be appraised annually to satisfy the regulatory requirements of ERISA. A savings association should use discretion within

these parameters. For example, appraisals or inspections for some types of property should be made more frequently, such as commercial office buildings, while appraisals or inspections for other types may be done less frequently, such as the grantor's residence or vacant land. Similarly, property under active management should be appraised or inspected more frequently than fractional interests in real estate where the savings association has no effective control.

Qualified and independent personnel should perform appraisals and inspections. Such personnel can be either internal or external. In either case the appraiser/inspector should be knowledgeable and have expertise in the type of property being appraised. The appraiser must also be independent from the transaction and property being appraised.

Where the savings association has investment responsibility, real estate should only be purchased or retained when it is appropriate for an account. The following is a partial list of the factors that should be considered in making an investment decision pertaining to real estate:

- Authority in the governing instrument or elsewhere to purchase, retain or sell real estate
- Suitability of the investment for the particular account
- Current appraisal of value, its future marketability, prospects for future appreciation/depreciation in value and cash flow
- Yield potential
- Tax benefits
- Assessment of risk factors, including environmental liability
- For leased property, terms of leases and creditworthiness of tenants
- Costs associated with real estate (taxes, insurance, maintenance, etc.) compared to other investment alternatives

Environmental Liability

Management should ensure that environmental risks are assessed prior to asset acceptance, including compliance with federal and state environmental law. Congress enacted the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), as amended by the Superfund Amendments and Reauthorization Act of 1986, to govern financial responsibility for cleaning up toxic waste. CERCLA is generally considered to be the primary environmental cleanup and liability law. Savings association should note that the Asset Conservation, Lender Liability and Deposit Insurance Protection Act of 1996 affords to lenders and fiduciaries liability relief from Section 107 of the CERCLA. Under §2502(a) of the Act, the liability of fiduciaries is limited to the assets held in their fiduciary capacity. Trustees will be found liable for the costs of environmental cleanups only if their negligence "causes or contributes" to the release of a hazardous substance on properties they hold in trust. Under new §107(n)(4) of CERCLA, fiduciaries do not face personal liability if they stay within the enumerated "safe harbors" of subsection (4) of Section 502. The legislation added a section to 42 U.S.C.A. §9607.

Real Estate Loans

Real estate notes and mortgages are most often received in kind as a result of the settlor having used them to facilitate the purchase and/or sale of real property. These interests may also be acquired as a result of the sale of real estate from an account in return for a mortgage or purchased outright. Most real estate loans are held in personal and employee benefit accounts which also hold a substantial portion of real estate itself or in employee benefit accounts where residential loans are made to participants in the account, up to their vested interest.

There are both advantages and disadvantages to investing in real estate loans. Real estate loans that are appropriate for the account and adequately secured are considered to be prudent investments and can be used to enhance a portfolio's overall yield. In most instances real estate loans are considered to be safe investments because of adequate collateral coverage. On the other hand, individual real estate loans usually are not readily marketable. In addition, it is not unusual for the quality of loans received in kind to be below that which a fiduciary would make on its own. Therefore, it is very important to have full documentation for all actions pertaining to real estate loans. Also, a major source of concern regarding real estate loans is when these assets become delinquent. Losses due to delinquencies are not limited to financial loss but also include the loss associated with expending resources to attempt to collect on loans and/or initiate foreclosure proceedings. To protect against possible loss, the savings association should have written policies and procedures that address the administration and supervision of delinquent real estate loans. Such policies should address the following:

- monitoring timely payment of outstanding balance;
- ensuring that delinquencies are tracked and corrected in a timely manner;
- reporting delinquencies to an appropriate level and/or committee;
- inspecting the property to forestall unknown deterioration and preserve value if foreclosure appears necessary; and
- establishing a plan for foreclosure.

The institution should have a system of internal controls to sufficiently monitor periodic but recurring activities such as loan, tax and insurance payments. These controls should consist of a tickler system and management information reports. Also, the discussion in the real estate subsection above concerning ancillary administration, insurance, appraisal and inspections is also relevant to real estate loans.

A fiduciary may also invest and participate in pools of real estate mortgages. Participation in mortgage investments enables the fiduciary to maintain portfolio diversity and reduce administrative costs. The individual fiduciary account and aggregate interest in these investments must be properly controlled. In the event of default, the savings association should determine that the participation agreements provide that each account bears only its pro rata share of loss. If such investments are purchased from an affiliate, the savings association should make sure that the inherent conflicts of interests involved are addressed, that the investment is prudent for the account and that the OTS's transaction with affiliates regulations are considered.

When making investment decisions concerning real estate loans, the institution should consider:

- value of the underlying parcel of real estate held as collateral;

- acceptable ratio of loan amount to current appraised value of the real estate;
- ability of the borrower to repay, including an analysis of the credit history;
- adequacy of the interest rate;
- documentation necessary to establish priority of lien and validity of loan; and
- adequacy of current insurance on the underlying real estate.

Mineral Interests

Mineral interests can be broadly defined as the property interest created in oil, gas or other minerals after severance by deed or lease and may exist for a fixed number of years, for a certain life or forever. Owners of mineral interests have the legal right to enter the property in order to explore, drill or carry on other similar activities. They also have the right to grant leases and assign all or part of their interest to others. There are different types of ownership interests in these types of assets that may be held in fiduciary accounts, including working interests and royalty interests. Trustees must properly manage oil, gas and mineral properties just as they administer all other types of assets held in fiduciary accounts. In most cases these assets would have been deposited in kind, rather than purchased by the savings association. The trust department must be fully familiar with these interests and employ outside expertise when necessary.

A mineral interest can be defined as the sum of all rights to oil, gas or to minerals on a property. Owners of mineral interests have the right to explore and drill on the property. They also have the right to grant oil and gas leases and are entitled to any lease bonus or delay rental that may be payable in connection with the lease. Mineral interest owners may assign all, a segregated portion or an undivided fractional share of their interest. When such assigned rights are limited in duration they are called “term minerals” while an assignment that is not limited is referred to as “perpetual minerals”.

A royalty interest is an interest in the underlying oil and gas reserves which is retained when an owner of land grants to another the right to determine the existence of commercial quantities of oil and/or gas on the property. In other words, a royalty interest is a mineral interest that does not have the rights and responsibilities of developing the property. A working interest is a mineral interest minus the royalty interest. The working interest is burdened with the cost of developing the property and the responsibility of operating the activity. The breakdown of ownership interests and payments is outlined in the division order. The most generally accepted fraction of mineral interest production is 1/8 to the royalty interest and 7/8 to the working interest. The fiduciary should carefully review and understand the provisions of the division order.

In the administration of oil, gas and mineral interests, the savings association should have written policies and procedures for proper supervision and administration. As is the case with other types of specialized assets, the potential for increased risk, liability or loss is directly related to the degree of experience and expertise available. Detailed and adequate record keeping is essential for proper administration. Each interest held in a fiduciary account should be thoroughly reviewed and documented. Important provisions should be very closely monitored to provide assurance that no event will occur without prior knowledge of the fiduciary. A monitoring system should include:

- type of interest owned;
- fractional share of interest owned and division orders;
- title records;

- description of the type of property leased;
- terms of the lease, including expiration date;
- name and address of lessee;
- amount of delay rental;
- date rent is due; and
- bonuses.

Due to the unique nature of mineral interests, the fiduciary may have problems properly monitoring such assets. Since valuations of mineral interests can be difficult, the savings association may wish to employ outside consultants, such as qualified geologists, landmen, engineers and accountants to determine the valuation and tax treatment of the mineral interest. Also, the savings association should keep in mind that mineral interests are considered illiquid and provide irregular income so it may be difficult to base income payments to beneficiaries on this type of asset.

Significant costs may be incurred by the fiduciary in the administration of mineral interests. The savings association should take additional costs into consideration when charging fees for their administration. These fees should be reviewed and approved by the board of directors and be disclosed in the fee schedule for fiduciary services.

Real Estate Interests Examination Program

Examination Objectives

To determine the adequacy and/or effectiveness of the trust department's administration of real estate interests. Consider whether management:

- has a full understanding of the scope and nature of responsibilities for real estate interests held;
- has established adequate and effective policies, procedures and internal controls for the administration of real estate interests;
- has provided for quality administration of real estate interests by ensuring adequacy of available expertise;
- monitors compliance with governing instruments, applicable law and accepted fiduciary principles; and
- initiates prompt corrective action when violations of governing instruments, applicable law or accepted fiduciary principles have been noted or when policies, procedures or internal controls are deficient.

Examination Procedures

Wkp. Ref.

Level I

Level I procedures first focus on a review of the examination scoping materials. The next step consists of interviews with trust department personnel to confirm their qualifications and levels of expertise; to determine if the trust department's practices conform to written guidelines; to establish whether any significant changes in personnel, operations or business practices have occurred; or whether new products and/or services have been introduced. If items of concern are uncovered during a Level I procedure or if problems are identified during the preexamination monitoring and scoping, the examiner may need to perform certain Level II procedures.

1. Review examination scoping materials related to the management of real estate and mineral interest investments. Scoping material should include:
 - Risk profile
 - Relevant PERK documents
 - Previous trust and asset management examination report

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- Workpapers from the previous examination
- Board of director and other applicable committee minutes
- Examination reports of subordinate functionally regulated entities

2. Evaluate the trust department's policies and procedures related to real estate interests. Review all significant changes to policies, procedures and practices. Consider the following items:

- How compliance with applicable law or standards of fiduciary conduct is ensured
- Preacceptance guidelines that address environmental and other risks associated with real estate interests
- Documentation requirements to support the appropriate administration of real estate and mineral interests contained in customer accounts, including: clear title; inspections and appraisals; acquisitions and disposals; rental, lease or property management; insurance requirements; taxes; ongoing monitoring; or other pertinent issues
- Required knowledge and expertise of management
- Delegation of real estate management and/or interests to third parties
- Authority and approval levels for exceptions to policy

3. Evaluate whether management has the necessary expertise to effectively administer real estate interests. Determine if any significant personnel and/or organizational changes (including changes in outside property managers) have occurred.

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4. Review a summary of real estate interest holdings in discretionary accounts. Determine that the policies and procedures have been established to adequately address the specific characteristics of each type of real estate interest held, including: personal residences; residential income properties; commercial properties; vacant land; property under construction; timberland, farm and ranch land; real estate loans; and mineral interests.
-
5. If administration of real estate interests is delegated to third parties, assess the selection and oversight process.
-
6. If there are material unresolved exceptions present from internal or external audit reports, compliance reports or examination reports, determine and evaluate the reasons for their presence. Evaluate management's plan to correct the exceptions.
-
7. Is the trust department accounting system adequate to handle real estate and mineral interests?
-
8. Are policies adequate to ensure that there is no leasing of mineral interests to savings association insiders, affiliates or their related interests?
-
9. Are fee schedules periodically reviewed to reflect appropriate charges for special services involving real estate and mineral interests?
-

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10. Consider whether the following risk contributors (if applicable) have been addressed:
- Does management fully understand all aspects of risk related to real estate investments?
 - Do policies and procedures address all significant activities?
 - Is management qualified to administer real estate interests?
 - Do management information systems and reports provide credible and comprehensive information?
 - Is the internal control environment adequate?
 - Are controls over outsourcing arrangements adequate?
 - Are environmental concerns properly managed?
 - Does management quickly identify weaknesses and take appropriate action?
 - Are there unresolved issues noted in audit, compliance or examination reports?

The completion of the Level I procedures may provide sufficient information to make a determination that no further examination procedures are necessary. If no determination can be made, proceed to Level II.

Level II

Level II procedures focus on an analysis of trust department documents such as reports and outsourcing contracts. The examiner should complete the appropriate Level II procedures when the completion of the Level I procedures does not reveal adequate information on which to base a conclusion that the trust department meets the examination objectives. Neither the Level I nor the Level II procedures include any significant verification procedures.

1. If agents are employed to manage real estate interests:

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- Are the qualifications and experience of the agent reviewed prior to employment?
 - Are the duties and responsibilities of the respective parties adequately set forth in a written agency agreement, including provisions relating to content and frequency of reports, authority to incur and pay expenses and compensation?
 - Is the agent's performance periodically evaluated?
-
2. Review and verify the accuracy of any applicable management exception reports.
-
3. Determine if the management systems are capable of monitoring and controlling income receipts, disbursements of expenses or other recurring activities.
-
4. Determine if appraisals are in accordance with state law or department policy.
-
5. Are appraisals and inspections made in accordance with trust department policy and are they performed by qualified and independent parties?
-
6. Evaluate how management handles environmental issues?
-
7. Evaluate the factors considered if management decides to purchase, retain or sell real estate loans. Are the factors considered adequate?
-
8. Does the payment of real estate taxes and insurance premiums receive prompt attention?
-

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9. Does the savings association ensure that proper evidence of title is obtained for oil or mineral holdings, such as the deed, division order or assignment of interest?
-
10. Have all lease forms and other legal documents required to hold title to various mineral interests been reviewed by legal counsel?
-
11. If necessary to validate an assertion, finding or concern arising from the completion of the Level I and II procedures, judgmentally select a limited number of accounts for review considering the degree of risk to the institution. Not all types of accounts need to be reviewed to arrive at a well-founded conclusion.
-

If the examiner cannot rely on the trust and asset management Level I and Level II procedures, or data contained in department records or internal or external audit reports, proceed to Level III.

Level III

Level III procedures include verification procedures that auditors usually perform. Although certain situations may require that Level III procedures be completed, it is not the standard practice of Office of Thrift Supervision (OTS) examination staff to duplicate or substitute for the testing performed by auditors.

1. Select a sample of directed accounts that hold real estate interests and determine that proper authorization exists, such as a current direction letter.
-

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2. Determine that the trust department is qualified to conduct business in the state where the real estate is located or that an ancillary fiduciary or agent has been appointed to administer the property.

3. Select a sample of different types of discretionary real estate interests for a detailed account review and determine whether real estate interests held are of trust quality and otherwise suitable for the accounts. If not considered suitable, determine what efforts are being taken to dispose of the interests. Determine the presence of the following:

- all relevant factors were considered prior to purchasing any interest in real estate and in the decision to retain any interest in real estate, including the investment objective of the account, yield on the real estate and tax implications;
- sufficient documentation is on file to support the investment decision and to support the proper administration of the account;
- clear and valid title has been obtained;
- proper authorization for purchasing or retaining any real estate interest is present in the governing instrument or other specific authorization;
- receipts showing current payment of taxes and insurance premiums are on file;
- copies of leases, rental agreements or documents pertaining to the specialized administration of particular properties are present;
- copies of inspection and appraisal reports are on file;
- environmental risk assessments, if applicable, have been performed; and
- all income and expenses are clearly documented and authorized.

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Optional Topic Questions

The following list of questions is offered merely as a tool and reference for the examiner and is not a required part of the examination process.

Policies and Procedures

| |
|---|
| Do the policy and procedures: |
| <ul style="list-style-type: none">• Before acceptance, require that holdings are reviewed and physically inspected to identify potential environmental liability or exposure? |
| <ul style="list-style-type: none">• Ensure clear title is obtained upon receipt of the property? |
| <ul style="list-style-type: none">• Require that essential documents, such as deeds, mortgages, insurance policies, contracts for sale, tax receipts, etc. are obtained? |
| <ul style="list-style-type: none">• Require appraisals and inspections, including the need to have updated values? |
| <ul style="list-style-type: none">• Require procedures for determining when ancillary trustee services will be required? |
| <ul style="list-style-type: none">• Address foreclosure practices? |
| <ul style="list-style-type: none">• Address effective rental and lease agreements or contracts? |
| <ul style="list-style-type: none">• Address qualifications of the real estate agents and managers used to manage property? |
| <ul style="list-style-type: none">• Require that fees paid to third parties are reasonable in relation to services provided? |
| <ul style="list-style-type: none">• Address tickler systems for tracking receipt of rental and lease payments and monitoring of delinquent payments? |

Property Conveyance

| |
|---|
| Are the following documents on file: |
| <ul style="list-style-type: none">• Original purchase and conveyance documents showing evidence of title (contract of sale (real estate); deed (real estate, real estate loan, mineral interest); note or mortgage (real estate loan); division order or assignment (mineral interest)? |
| <ul style="list-style-type: none">• An updated appraisal report from a qualified individual? |
| <ul style="list-style-type: none">• Title insurance or other documentation considered necessary to demonstrate clear title? |
| <ul style="list-style-type: none">• Insurance policies (e.g., for property or liability coverage), and current paid receipts? |
| <ul style="list-style-type: none">• Property tax receipts? |
| <ul style="list-style-type: none">• Any other information pertinent to the interest (leases, mortgages, liens or releases (real estate); documents relating to security and collateral (real estate loan); leases, licenses, permits, operating agreements (mineral interest))? |

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Appraisals and Inspections

| |
|--|
| Are appraisals and inspections: |
| <ul style="list-style-type: none">• Performed by qualified and independent personnel? |
| <ul style="list-style-type: none">• Obtained prior to purchase? |
| <ul style="list-style-type: none">• Made in accordance with, as applicable, state law or governing instrument requirements, trust department policy or sound fiduciary principles? |

Real Estate Administration

| |
|--|
| Are the following items monitored and controlled: |
| <ul style="list-style-type: none">• Adequate insurance is maintained in accordance with, as applicable, state law or governing instrument requirements, department policy or sound fiduciary principles? |
| <ul style="list-style-type: none">• Payment of real estate taxes? |
| <ul style="list-style-type: none">• Payment of insurance premiums? |
| <ul style="list-style-type: none">• Collection of rent or other income? |
| <ul style="list-style-type: none">• Payment of expenses? |

Mineral Interests

| |
|---|
| Are all the following relevant factors considered prior to purchasing or retaining any mineral interests? |
| <ul style="list-style-type: none">• The status of the interest received (such as whether it is leased, producing or nonproducing, its location, etc.)? |
| <ul style="list-style-type: none">• Is the department's accounting system adequate for handling mineral interests? |
| <ul style="list-style-type: none">• Are interests leased only in accordance with standardized procedures which address such items as the following:<ul style="list-style-type: none">• The form of lease agreement to be used.• Fees to be charged.• Responsibility for maintenance of insurance coverage.• Counsel or an appropriate committee reviews lease agreements prior to execution review.• The department maintains a system to monitor and control the following:<ul style="list-style-type: none">▪ Lease and royalty payments, including delinquencies.▪ Delayed rental payments on nonproducing interests.▪ Expiration of leases and insurance.▪ Receipt of income, including expected due date.▪ Disbursement of expenses. |

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- | |
|--|
| ▪ Any other special or recurring activities. |
| • Are guidelines in effect to avoid leasing mineral interests to employees of the savings association and other related parties? |

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Introduction to Miscellaneous Assets

The assets outlined and discussed previously are those most commonly found in fiduciary accounts. However, they are not the only assets that may be held. Several other types of assets, referred to collectively as “miscellaneous assets” may be encountered. Examples of these assets include restricted securities, private placements, options, futures, forwards, repurchase agreements, partnerships, loans other than real estate, tangible assets and worthless securities. These assets are not frequently purchased by fiduciaries; rather they are generally used to initially fund a trust. In some cases, testators, grantors, beneficiaries or other parties having powers to direct the trustee may have expressed their wishes to have such investments either acquired or retained by an account. The fiduciary must refer to applicable law when determining the appropriateness of such assets.

Restricted Securities

Restricted securities are those securities acquired directly or indirectly from the issuer of the securities or from an affiliate of the issuer, in a transaction or a series of transactions not involving a public offering. When a savings association encounters these securities it must comply with Rule 144 of the Securities and Exchange Commission in order to sell them. This rule was adopted to establish objective standards in connection with the sale of unregistered securities for determining when a person is presumed not to be an underwriter or distributor of the securities. In order to meet these objective standards, which allow the securities to be sold without a public registration, the person(s) from whose account the securities are sold must have been the beneficial owner(s) of the securities for a period of at least two years. The amount of securities sold must not exceed the established limits. The amount to be sold in any three-month period cannot exceed the greater of one percent of the outstanding securities of the class being sold or the average weekly trading volume for the class during the four-week period preceding the sale. The securities must be sold either in a broker’s transaction or in transactions directly with a market maker. In addition, adequate information regarding the issuer must be available to the public and a notice of sale (Form 144) must be filed with the SEC, unless the amount of securities sold in any three-month period does not exceed 500 shares and the sale price does not exceed \$10,000.

Private Placements

Private placements represent the sale of an entire class of securities to a small group of investors. Section 4(2) of the Securities Act of 1933 provides an exemption from registration for transactions not involving any public offering. Advantages of private placements may include increased portfolio yields, saving of registration costs by the issuer, the ability of the investor and issuer to tailor the offering through negotiation to meet the needs of both parties and the completion of the transaction without being subject to regulatory and public scrutiny. The primary disadvantage of the private placement is that it is highly illiquid. Due to it being privately negotiated, no secondary market exists and therefore the security may have to be held until maturity.

Stock Options, Forward Contracts and Financial Futures

These investments are discussed together due to the similarity of factors that should be considered by the fiduciary in making an investment decision as to the appropriateness for the account. These investments should be considered neither inherently prudent nor imprudent. Rather their use should be considered in relation to the individual account objectives and the expertise and knowledge of the investment personnel

utilizing them. The investment policy and procedures should specifically detail the process and risk parameters for using such investments.

Repurchase Agreements

A repurchase agreement is an acquisition of funds through the sale of securities, with a simultaneous agreement by the seller to repurchase the securities at a later date. Basically, a repurchase agreement is a secured borrowing by which an owner of securities leverages existing positions by pledging securities against the repurchase liability. A reverse repurchase agreement is an acquisition of securities or certain rights to securities by an investor under a simultaneous agreement to resell the securities. Repurchase agreements that are entered into with an affiliate represent loans by the trust account to an affiliate and involve a conflict of interest and may be in violation of the OTS's transaction with affiliates regulations. The following guidelines should be considered when investing in repurchase agreements:

- Investment personnel must know the financial condition of the parties with whom they are doing business, including a credit analysis
- Avoid concentrations with one firm
- Responsibilities and duties of the participants should be outlined in formally written contracts.

Partnerships

A partnership is generally defined as the association of two or more persons to carry on a business for a profit. Investments in partnerships can offer the advantages of high investment return and/or tax sheltered income. On the other hand, disadvantages of partnerships can include their lack of liquidity and potential for loss. Unlike a corporation, a partnership is not a legal entity. As a result the debts of the partnership become the debts of the individual partners and any one partner may become liable for the total debts of the partnership. This liability can be mitigated through the formation of a limited partnership.

Limited partnerships are usually comprised of a general partner and limited partners. The general partner is responsible for the overall management of the project and the day-to-day operations. The general partner is fully liable for the debts of the partnership. The limited partner is not involved in the day-to-day management of the project and has liability that is generally limited to their capital contribution. Limited partners receive income, capital gain and other tax benefits, while the general partner collects a percentage of capital gains and income. The savings association, in its fiduciary capacity should not take on the role of general partner due to the fact that liability is not limited to the principal of the particular account. For limited partnership interests, the savings association must ensure that such an investment is prudent and meets the objectives of the account.

The valuation of these assets is very important. Many limited partnerships have little or no market value. The savings association must have a process to ensure that it has the ability to obtain current fair market values for such investments. Failure to properly value limited partnerships may lead to inaccurate fees as well as potential compliance issues. Specifically, employee benefit plans subject to ERISA require that all plan assets be valued at a reasonable market price on an annual basis and reported on the plans Annual Report (Form 5500). Proper valuations are also required for IRA account tax filings.

Non-Real Estate Loans

The investment decision to acquire and/or retain a loan for a fiduciary account must be supported by a thorough analysis. There are both advantages and disadvantages to such assets. The savings association however, should consider the following factors when making lending decisions:

- appropriateness in meeting account objectives;
- creditworthiness and the ability of the borrower to repay;
- probability of loan collection without liquidation of collateral;
- acceptability and marketability of collateral, if any;
- collateral value to loan ratio; and
- possibility of distributing the loan to a beneficiary if the loan is made to that party.

Tangible Assets

Tangible assets refers to assets such as works of art, coins, stamps, antiques, bullion, precious stones, furs and other types of tangible personal property or collectibles. Tangible assets are usually found in estates and personal trust accounts and are generally distributed out to beneficiaries at the close of the trust or estate or they may be sold to meet liquidity needs. Advantages of tangible assets can include their use as a hedge against inflation and the fact that they might appreciate in value at a greater rate of return than other investments. Disadvantages include the lack of current income, illiquidity, storage, insurance costs and exposure to theft and fraud. Proper valuation of such assets is difficult and often costly.

The savings association should have appropriate policies and procedures in place to assist in administering these assets. It is important for the savings association to have the requisite expertise, either internally or through an agent, to properly oversee the management of these assets. Valuation appraisals should be obtained on a periodic basis to ensure adequate insurance. Dual control and record keeping are needed to guard against the theft. The savings association is also responsible for the proper storage and custody.

Worthless Securities

Occasionally a savings association will accept securities that have been used to fund the trust, which are deemed to be worthless. Securities are considered worthless or obsolete when they have no current value. This may happen when an issuing company is no longer in business but has not been legally dissolved. The savings association still has responsibilities toward these securities despite the lack of value. Its responsibility to safeguard assets extends to all assets. These assets may regain value at a later date and become valuable to the account.

Before concluding that a security is worthless, the savings association should make a reasonable effort to determine if any value remains in the security. The trust department should have an established policy and procedure that include the steps to be taken when it encounters such assets. The first step the savings association should take is to contact the state corporation commission or secretary of state, to ascertain whether or not the corporation still operates. Once the lack of value has been determined and documented, effective accounting and monitoring controls are needed. The most common methods are to either retain the security in the individual account at a nominal value or place the security in a suspense account for worthless

securities. In either case, the savings association should maintain a list and keep all worthless securities in the vault under dual control. These securities must be monitored periodically.

Miscellaneous Assets Examination Program

Examination Objectives

To determine the adequacy and/or effectiveness of the trust department's administration of miscellaneous assets. Consider whether:

- management has a full understanding of the risks and responsibilities associated with miscellaneous assets;
- management has adopted policies and procedures and effected sound internal controls for the acceptance, acquisition, maintenance, disposal and administration of miscellaneous assets;
- adequate expertise is available to administer miscellaneous assets;
- policies and procedures are in place to ensure compliance with governing instruments, applicable law and accepted fiduciary principles; and
- deficiencies are identified and corrective action is promptly initiated.

Examination Procedures

Wkp. Ref.

Level I

Level I procedures first focus on a review of the examination scoping materials. The next step consists of interviews with trust department personnel to confirm their qualifications and levels of expertise; to determine if the trust department's practices conform to written guidelines; to establish whether any significant changes in personnel, operations or business practices have occurred; or whether the new products and/or services have been introduced. If items of concern are uncovered during Level I procedures or if problems are identified during the preexamination monitoring and scoping; the examiner may need to perform particular Level II procedures.

1. Review examination scoping materials related to the selection and oversight process for miscellaneous assets. Scoping material should include:
 - Risk profile
 - Relevant PERK documents
 - Previous trust and asset management examination report

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Miscellaneous Assets Examination Program

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- Workpapers from the previous examination
- Previous safety and soundness examination report
- Examination reports of subordinate, functionally regulated entities
- Board and other appropriate committee minutes

2. Evaluate the policies, procedures and practices related to miscellaneous assets. Note any significant changes. Consider:

- how compliance with applicable law, accepted fiduciary principles, governing instruments and policy is ensured;
- the process and criteria, by which miscellaneous assets are accepted, selected and approved;
- the documentation required to support the administration of each type of miscellaneous asset, including valuation;
- the use of outsourcing arrangements to manage or administer miscellaneous assets;
- the use of custodial arrangements and access controls; and
- how exceptions to policy and defined authority levels are handled.

3. Evaluate whether management and staff have the knowledge and expertise to administer miscellaneous assets. Note any personnel and/or organizational changes.

4. If miscellaneous asset administration is outsourced to third parties, assess the selection and oversight process.

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5. Review custodial arrangements and access controls for miscellaneous assets. Assess if they are adequate. Confirm that the assets, custodial arrangements and access controls are subject to audit.

-
6. Consider whether the following risk contributors (if applicable) have been addressed:
- Does management anticipate and respond well to market and technological changes?
 - Are management information reports comprehensive and credible?
 - Does management satisfactorily review and assess exceptions to policy?
 - Does management quickly identify weaknesses and take appropriate action?
 - The correction of material issues noted in audit, compliance or examination reports.

7. Are there adequate acceptance policies and procedures for determining if new accounts contain securities that are worthless? Do the policies and procedures detail how that determination is to be made?

The completion of the Level I procedures may provide sufficient information to make a determination that no further examination procedures are necessary. If no determination can be made, proceed to Level II.

Level II

Level II procedures focus on an analysis of trust department documents such as reports and outsourcing contracts. The examiner should complete the appropriate Level II procedures when the completion of the Level I procedures does not reveal adequate information on which to base a conclusion that the trust department meets the examination objectives. Neither the Level I nor the Level II procedures include any significant verification procedures.

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1. If miscellaneous asset administration is outsourced to third parties:
 - Review management's due diligence documentation for the selection process.
 - Review the duties and responsibilities of the respective parties as set forth in a written agreement. Is the third party performing according to the agreement?
 - Is the cost appropriate considering the third parties performance?

2. If there are unresolved exceptions from internal or external audit reports, compliance reports or examination reports, determine why. Evaluate management's plan for correction.

3. Review and verify the accuracy of any applicable management exception report.

4. Review the miscellaneous asset holding list and note if the trust department, through all of its accounts, tends to have concentrations of any particular type of miscellaneous asset. Determine if this presents a risk to the savings association.

5. Note if any trust department accounts contain unsecured loans. Did management consider the creditworthiness of the borrower?

6. Evaluate management's controls for accepting unsecured loans. Are the tickler systems adequate to monitor payments, appraisals, inspections and insurance?

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7. Does the trust department accept tangible assets, such as art, coins, stamps, precious stones, etc.? Is there proper storage space to maintain these assets?

8. Does the trust department accept partnerships? If so, what type? If limited partnerships are accepted, determine how and how often they are valued.

9. If accepted, how does management handle restricted securities, private placements, options, futures, forwards or repurchase agreements?

10. If necessary to validate an assertion, finding or concern arising from the completion of the Level I and II procedures, judgmentally select a limited number of accounts for review considering the degree of risk to the institution. Not all types of accounts need to be reviewed to arrive at a well-founded conclusion.

If the examiner cannot rely on the trust and asset management Level I or Level II procedures, or data contained in department records or internal or external audit reports; proceed to Level III.

Level III

Level III procedures include verification procedures that auditors usually perform. Although certain situations may require that Level III procedures be completed, it is not the standard practice of Office of Thrift Supervision (OTS) examination staff to duplicate or substitute for the testing performed by auditors.

1. Select a sample of discretionary accounts containing different types of miscellaneous assets for review. Determine the reason for holding and whether the assets are suitable for the accounts. Consider the following:

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- documentation to support the acceptance, purchase, ongoing analysis and retention of miscellaneous assets considering the accounts' investment objective, risk tolerance, liquidity needs and tax implications;
- management and staff are qualified to monitor and evaluate miscellaneous assets;
- the purchase or retention of miscellaneous assets is in compliance with the governing instrument and applicable law;
- management information systems have adequate tickler systems;
- all income, expenses and other activities associated with miscellaneous assets are promptly and accurately recorded; and
- whether controls and safeguards over miscellaneous assets (i.e., works of art or antiques) are adequate.

2. Select a sample of directed accounts to review. Determine that current directions and authorizations are on file.

3. Compare the results or deficiencies noted with the findings of the audit/compliance reviews. Determine the reasons for any inconsistencies or discrepancy.

4. Determine if restricted securities are administered in accordance with SEC Rule 144. Test accounts for compliance.

5. Determine if any options, repurchase agreements or similar assets are subject to trading restrictions. If so, are they earmarked and properly controlled on ledgers for identification and monitoring? Determine if particular accounts have any dollar volume, position limits or other restrictions and limitations.

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**Miscellaneous Assets Examination
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Examiner's UITRS Rating, Summary, Conclusions and Recommendations:

References - 860P

Laws

ERISA
Securities Act of 1933 Section 4(2)

Code of Federal Regulations

12 CFR 550.240 Trust Powers
12 CFR 550.260 Investment of Funds Held as Fiduciary

Office of Thrift Supervision Publications

Other

Scott on Trusts, 3rd Edition
Bogert and Bogert, Trust and Trustees, 2nd Ed.
Restatement (Second and Third) of Trusts

Workpaper Attachments - 860P

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Miscellaneous Assets Examination Program

Optional Topic Questions

The following list of questions is offered merely as a tool and reference for the examiner and is not a required part of the examination process.

| |
|--|
| <i>Policies and Procedures</i> |
| <ul style="list-style-type: none">• Are the policies reviewed and approved by the board of directors? |
| <ul style="list-style-type: none">• Is there sufficient knowledge and expertise available to properly and prudently administer these assets? |
| <ul style="list-style-type: none">• Do the policies address the purchase, sale and retention of the following types of miscellaneous assets:<ul style="list-style-type: none">• Loans• Tangible assets• Partnership interests• Worthless securities• Restricted securities• Private placements• Options, futures, repurchase agreements and other similar assets• Any other miscellaneous assets held |

Acceptance and/or Purchase

| |
|--|
| <ul style="list-style-type: none">• Are prospective acquisitions reviewed to determine the nature of the responsibilities to be performed and if sufficient administrative and operational expertise exists or is available? |
| <ul style="list-style-type: none">• When these assets are received (either in kind or by purchase), does the department take such steps as are necessary to establish ownership? |
| <ul style="list-style-type: none">• Is the decision to purchase, retain or sell consistent with the needs and objectives of the individual account? |
| <ul style="list-style-type: none">• Is the purchase, retention or sale clearly authorized by the governing instrument, applicable law or written authorization? |

Loans secured by assets other than real estate

| |
|--|
| Ensure appropriate factors are considered in making an investment decision. Do they include: |
| <ul style="list-style-type: none">• Provisions of the governing instruments? |
| <ul style="list-style-type: none">• Acceptability and marketability of collateral? |

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|--|
| <ul style="list-style-type: none">• Collateral value to loan ratio? |
| <ul style="list-style-type: none">• Credit worthiness of the borrower? |

Administration of loans

Are the following practices and procedures in place:

- | |
|---|
| <ul style="list-style-type: none">• Tickler systems adequate to assure prompt payment. |
| <ul style="list-style-type: none">• Procedures adequate to address the handling of delinquent loans. Are they followed? |
| <ul style="list-style-type: none">• Is collateral subject to periodic valuation, appraisal or inspection? |
| <ul style="list-style-type: none">• Is there sufficient collateral value to protect the savings association's interest? |
| <ul style="list-style-type: none">• Necessary steps are taken to comply with any UCC or state law requirements regarding the filing and perfection of security interests? |

Administration of tangible assets

Are the following practices and procedures in place:

- | |
|--|
| <ul style="list-style-type: none">• Proper control, storage, authentication and insurance? |
| <ul style="list-style-type: none">• Appraisals or valuations conducted periodically or when necessary? |

Management of worthless securities

Are the following practices and procedures in place:

- | |
|---|
| <ul style="list-style-type: none">• The savings association has taken reasonable steps to ascertain the value of such securities? |
| <ul style="list-style-type: none">• The securities are identified and maintained under proper accounting controls? |

Options, futures, repurchase agreements

Are they subject to written policies and procedures which address the following:

- | |
|---|
| <ul style="list-style-type: none">• Steps for determining whether the investment is in accordance with applicable law? |
| <ul style="list-style-type: none">• Dollar volume, position limits or other restrictions and limitations of the investment for particular accounts? |
| <ul style="list-style-type: none">• Methods of reporting and approving the transaction? |
| <ul style="list-style-type: none">• Accounting and record keeping practices? |
| <ul style="list-style-type: none">• Auditing and other internal control safeguards? |

Other

- | |
|---|
| <ul style="list-style-type: none">• Are any restricted securities administered in accordance with SEC Rule 144? |
|---|

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|---|
| <ul style="list-style-type: none">• Are investments in private placements analyzed and evaluated in accordance with the given restrictions? |
| <ul style="list-style-type: none">• Are options, repurchase agreements or similar assets subject to any trading restrictions, specifically identified and properly controlled on the savings association's ledgers? |

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Introduction to Insurance Products

There are many types of insurance products that may be found in a trust department. Some insurance products may be more commonly sold to and held by private banking clients, while some trust department accounts may be solely invested in a life insurance product.

Examiners should consider whether insurance products held by trust department accounts are appropriate for the account and whether there is a system in place to analyze any conflicts of interest, if the account holds an the insurance product of an affiliate.

Irrevocable Life Insurance Trusts (ILIT)

Irrevocable life insurance trusts, commonly referred to as “ILITs” are becoming more widely used in estate planning as a means to transfer wealth without having to pay estate taxes on the transfer. Normally, the value of insurance policies, owned by a decedent, are included in the decedent’s estate for estate tax purposes. This is true even if the proceeds are paid to a designated beneficiary other than the decedent’s estate. However, if an ILIT is used to hold the “incidents of ownership” of a life insurance policy, it will allow the proceeds of the policy to escape being included in the grantor’s estate when he/she dies, thus avoiding the payment of estate taxes on the value of the life insurance policy. Many savings associations are providing trustee services to irrevocable life insurance trusts.

A conflict of interest for a savings association occurs when the life insurance policy is sold or underwritten by an affiliate of the savings association. In most cases, specific language will be present in the trust instrument creating the ILIT that will allow a trustee to purchase and/or hold an insurance policy sold and/or underwritten by a savings association, its subsidiaries or affiliates. Such language in the trust instrument resolves the conflict of interest but state law, a court order or consent of all the beneficiaries may also be utilized to resolve any conflicts of interest.

Savings associations performing trustee services for these ILITs must also meet their duties of prudence in regards to the selection and continued holding of the life insurance policy (ies) which represent a significant portion of the assets of the irrevocable life insurance trust. The savings association should document all the benefits that it, its affiliates and its subsidiaries receive in connection with the purchase, holding or sale of the life insurance policy as well as the benefits that particular policy presents to the life insurance trust. The subject of diversification of trust account investments must also be addressed under the applicable state’s prudent man/prudent investor statute. In most cases, the trust instrument creating the ILIT will direct the trustee to purchase and continue to hold a significant amount of trust account assets in life insurance policies, since the life insurance trust typically represents just one element of a diversified and integrated plan of family wealth management.

In an ILIT, the trust takes title to the life insurance policy, becoming its owner and the recipient of the proceeds of the insurance policy at the insured’s death. When the insurance benefit is paid after the death of the insured, the trustee collects the funds, makes them available to pay estate taxes and/or other expenses (including debts, legal fees, probate costs and income taxes that may be due on IRAs and other retirement benefits) and then distributes the remaining funds to the trust beneficiaries. The premiums of the life insurance policy are paid by the grantor/insured by making gifts, through the trustee, to the trust beneficiaries of the ILIT. Such gifts are generally made free of gift tax through the use of “Crummey” provisions.

The term “Crummey” provisions refers to the language in the trust document creating the ILIT that indicates that the grantor will make periodic cash payments to the trust. The cash payments are meant to be used to pay the premiums of the life insurance policy held by the trust but in accordance with the provisions of the trust document, the beneficiaries of the trust have a specified period of time (usually 30 days) to make a withdrawal of those cash payments. If the beneficiaries do not withdraw their respective amounts, the money is then used to pay the premiums due on the life insurance policy. The IRS has ruled that such an arrangement represents a gift of present value interest by the grantor. Since it is a gift of present value, the grantor may contribute up to \$10,000 (\$20,000 if the grantor and the grantor’s spouse join in the contribution) per year per beneficiary in premium payments and enjoy the gift tax exclusion.

Savings associations that act as trustee for ILITs assume certain duties in connection with these trusts. The first duty is administrative in nature and includes sending the required crummy notices before the payment of the premium and with sufficient time for the beneficiaries to choose to remove any funds and to also file an annual gift tax return to claim and allocate any generation-skipping transfer tax exemption. Savings associations may also be faced with decisions in regards to the demutualization of life insurance companies that have issued policies held by the trust. In these situations, savings associations should document its decisions regarding the demutualization election, the choice of receipt of benefits as a result of the demutualization and any investment decisions relating to the benefits received. As there may be estate, gift and income tax consequences relating to the demutualization, savings associations are urged to seek a reasoned opinion of counsel as to the tax effects on the ILITs as a result of its decisions, but such opinion need not be specific as to each account. The other duties that savings associations have in connection with these types of trusts revolve around the continued review of the life insurance policy (ies) to confirm that the policies held by the trust continue to be a prudent investment, taking into consideration any relevant language in the trust document or under applicable state law.

This review should be conducted on an annual basis and the savings association should document its decision making as to the continued retention of the policies in light of any premium payment option changes or conversion provisions of the policy that might be triggered by some event. The savings association should also document its review of the solvency and financial health of the insurance companies issuing the policies. In its review, the savings association should take into consideration certain assumptions that were made when the policy was originally purchased or the ILIT created, about the insured’s financial situation, life expectancy, health condition, number of dependents and other factors. Those factors can change while the insured is still alive, possibly rendering a life insurance policy inadequate, obsolete or no longer appropriate. Savings associations should be reviewing the policies to make sure that the trust does not continue to hold policies that have become inadequate or inappropriate.

Insurance Products and Services

Life Insurance

Life insurance is a tool that can be utilized relative to an individual’s overall financial plan. The primary purpose of life insurance is to financially protect the insured’s survivors in the event of the insured’s premature death; however, life insurance products can be utilized for other planning purposes as well. There are four primary types of life insurance policies, term, whole-life, universal and variable.

Term insurance

Term insurance is a contract that obligates the insurer to pay the policy’s face value if the insured dies within a specified period. If the insured survives the contract period, the contract expires without any value. Term

insurance is temporary and at some point in time it disappears. There are various terms available, such as straight, yearly renewable, convertible, combination or the usual form, level term. Premiums are usually inexpensive in the beginning and tend to increase with age.

Whole life insurance

Whole life insurance is a type of permanent insurance with cash-value accumulation. Whole life provides resources after death regardless of when the insured dies. It can be used as a savings plan for emergencies or for funding a retirement income. Generally, no cash is available for the first three years of the policy and it takes about seven to eight years afterward to break even. The client can borrow against the policy, can alter the policy and can quit at any point in time.

Universal life insurance

Universal life insurance is also a type of insurance with cash value. Life insurers developed this policy to combine the advantages of cash-value life insurance with the higher yields possible through investment vehicles. Universal life divides death protection and cash-value into separate components. It is distinguished from traditional cash-value policies, which are indivisible contracts with unified death protection and cash-value accumulations. With universal life, more competitive rates of return can be guaranteed and greater flexibility can be achieved by adjusting the amounts of savings and protection to the needs of the insured. The flexibility is an important advantage as the policy owner passes through the life cycle. There is no premium guarantee.

Variable life insurance

Variable life insurance provides a minimum face amount of insurance but allows the policy proceeds to increase beyond this amount if the value of the investment portfolio supporting the policy increases. Cash values fluctuate with investment returns. The insured directs the investment portion (usually mutual funds); therefore, the owner is taking the risk not the company. As the cash value decreases, the death benefit also decreases. The premium is comparable to universal life policies.

Variable universal life policy

Fairly new, a variable universal life policy combines features of variable and universal life policies. The holder of this policy enjoys the investment risks and rewards characteristic of variable life insurance, coupled with the ability to adjust premiums along with a death benefit that is characteristic of universal life insurance.

Disability Insurance

Private disability insurance is sold in a variety of plans to meet personal and business needs when the insured is unable to work and suffers a loss of income as a result of sickness or injury. This type of insurance provides a periodic payment on an “occupational” basis when the insured is unable to perform specific job related duties or on a “residual” basis when the insured is at work at reduced earnings. Personal disability income insurance is available from commercial insurance companies. Most business disability income insurance is sold only on an individual basis.

Long-Term Care Insurance

Long-term health care insurance is not an income replacement but a supplemental policy that pays above and beyond Medicaid and Medicare. It is purchased in ten dollar increments depending on the extent of nursing

home care desired. Nursing homes offer three types of care, custodial, intermediate and skilled. A physician determines the services needed. In addition to the policy purchased, a home health care rider can be purchased that will allow the purchaser to remain in their own home for treatment. The typical age to purchase long-term care insurance is between the ages of 45 and 65.

Homeowner Policies

There are five form types of homeowner policies, differing based on the terms of the perils covered under the policy. The five forms are: broad form coverage (for dwelling, other structures and personal property), open peril coverage (for dwelling and other structures), renter's policy (coverage for personal property), condominium unit owners policy and modified coverage form.

Variable Annuities

Variable annuities have become a part of the retirement and investment plans of many clients. A variable annuity is a contract between the client and the insurance company under which the insurer agrees to make periodic payments to the client, beginning either immediately or at some future date. A client purchases a variable annuity by making either a single purchase payment or a series of purchase payments. Variable annuities offer investment features similar in respect to a mutual fund. A typical variable annuity, however, offers three basic features not commonly found in a mutual fund; tax-deferred treatment of earnings, a death benefit and annuity payout options that can guarantee income for life.

Variable annuities are designed for long-term investments for retirement. Withdrawals prior to the age of 59 ½ are generally subject to a 10 percent penalty under the Internal Revenue Code. Many variable annuities assess surrender charges for withdrawals within a specified time period after purchase. Variable annuities assess various fees including fees related to the insurance features.

A variable annuity is an insurance contract that is subject to regulation under state insurance and securities laws. A client's premium payments to purchase a variable annuity are allocated to underlying investment portfolios, often termed subaccounts. The value of the underlying subaccounts will fluctuate in response to market changes and other factors depending on the underlying investment(s). Because the contract owners assume the investment risks, variable annuities are securities and generally must be registered under the Securities Act of 1933. A distributor of variable annuity contracts to individuals is required to register as a broker-dealer under the Securities Exchange Act of 1934 and become a member of the NASD. The distribution of variable annuity contracts is subject to NASD rules for suitability and replacement sales.

Insurance Products Examination Program

Examination Objectives

To determine the adequacy and effectiveness of the trust department's administration of insurance products. Consider whether:

- effective policies, procedures and internal controls have been established for the acceptance and administration of irrevocable life insurance trust accounts, including an annual review of each insurance policy;
- an effective audit, risk management and/or compliance process is in place that reviews the decision making process regarding the use of affiliated insurance products in discretionary accounts;
- policies and procedures ensure compliance with governing instruments, applicable law and accepted fiduciary principles;
- management and staff have the necessary expertise to assess insurance products; and
- when deficiencies are identified, corrective action is promptly initiated.

Examination Procedures

Wkp. Ref.

Level I

Level I procedures first focus on a review of the examination scoping materials. The next step consists of interviews with trust department personnel to confirm their qualifications and levels of expertise; to determine if the trust department's practices conform to written guidelines; to establish whether any significant changes in personnel, operations or business practices have occurred; or whether the new products and/or services have been introduced. If items of concern are uncovered during Level I procedures or if problems are identified during the preexamination monitoring and scoping; the examiner may need to perform certain Level II procedures.

1. Review examination scoping materials related to the administration of irrevocable life insurance trusts and the use of insurance products. Scoping material should include:
 - Risk profile
 - Relevant PERK documents
 - Previous trust and asset management examination report

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Insurance Products Examination Program

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- Workpapers from the previous examination
- Examination reports of subordinate, functionally regulated entities
- Board and other applicable committee minutes

2. Evaluate the trust department's policies, procedures and practices related to irrevocable life insurance trust accounts and insurance products, noting any significant changes.
Consider:

- whether compliance with applicable law, standards of fiduciary conduct, governing instruments and policy are ensured;
- the process, including documentation, by which insurance companies and insurance policies are reviewed;
- the use of affiliates or other third parties to administer life insurance trusts or evaluate life insurance policies or companies;
- management of the conflict of interest issues surrounding the use of affiliated insurance products; and
- the handling of exceptions to policies and procedures.

3. Determine whether management and staff have the knowledge and expertise to administer life insurance trusts and other types of accounts that are invested in insurance products such as term, whole life, universal life and variable life policies and annuities.

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4. Review and evaluate the analysis, selection, approval and removal process with respect to insurance companies and their products and services when the trust department has investment discretion.

5. If the administration or evaluation of life insurance policies and products is outsourced to third parties, assess management's selection and oversight process. Consider whether:

- management's due diligence process is thorough, including assessing the qualifications and experience of the third party; and
 - the duties and responsibilities of the respective parties are set forth in a written agreement, including provisions relating to the content and frequency of reports and the authority to incur and pay expenses and compensation.
-

6. Consider management's process for identifying conflict of interest issues when affiliated insurance products are used in discretionary accounts.

7. If affiliated life insurance products are used in discretionary accounts confirm that there is a process to assure that all the provisions of OTS TB 76-2 are met regarding state conflict of interest and prudent investment statutes.

8. Consider whether the following risk contributors (if applicable) have been addressed:

- Does management fully understand all aspects of risk with respect to irrevocable life insurance trust accounts and/or the use of insurance products in discretionary accounts?
- Are policies and procedures adequate?

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- Does management anticipate and respond well to market and technological changes?
 - Is investment research and analysis sound?
 - Are management information reports comprehensive and credible?
 - Is the internal control environment adequate?
 - Does management satisfactorily review and assess exceptions to policy?
 - Does management quickly identify weaknesses and take appropriate action?
 - Are there unresolved insurance product issues noted in audit, compliance or examination reports?
-

The completion of the Level I procedures may provide sufficient information to make a determination that no further examination procedures are necessary. If no determination can be made, proceed to Level II.

Level II

Level II procedures focus on an analysis of trust department documents such as reports and outsourcing contracts. The examiner should complete the appropriate Level II procedures when the completion of Level I procedures does not reveal adequate information on which to base a conclusion that the trust department meets the examination objectives. Neither the Level I nor the Level II procedures involve significant verification procedures.

1. If there are unresolved exceptions present from internal or external audit reports, compliance reports or examination reports, evaluate the reasons for their presence and management's plan for correction.
-

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2. Determine if there is a process to review discretionary accounts that have insurance policies as investments. Are policies reviewed to determine suitability? Are the following factors considered: the cost of the policy or product, unique terms, level of risk, financial stability of the issuer, liability issues and tax implications.

3. For irrevocable life insurance trusts, do the policies require that all crummy provisions are met, including timely notices to beneficiaries? Are the notices in conformance with applicable law and the governing document?

4. If third parties are engaged to administer life insurance trusts and/or products, is the performance of the third party periodically evaluated and the evaluation documented?

5. If necessary to validate an assertion, finding or concern arising from the completion of the Level I and II procedures, judgmentally select a limited number of accounts for review considering the degree of risk to the institution. Not all types of accounts need to be reviewed to arrive at a well-founded conclusion.

If the examiner cannot rely on the trust and asset management Level I or Level II procedures, or data contained in department records or internal or external audit reports to form a conclusion; proceed to Level III.

Level III

Level III procedures include verification procedures that auditors usually perform. Although certain situations may require that Level III procedures be completed, it is not the standard practice of Office of Thrift Supervision (OTS) examination staff to duplicate or substitute for the testing performed by auditors.

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1. From the discretionary account list, select a sample of accounts containing different types of life insurance policies or products. Consider the following:
 - The insurance policy is from a company on the trust department's approved list. If not, has a reasonable explanation been documented in the file?
 - Documentation is present to support the acceptance and/or purchase and ongoing analysis and valuation of the life insurance policy or product in view of the investment objective of the account.
 - Whether the purchase or retention of the life insurance policy or product is in accordance with applicable law. Does applicable state law remove liability from the trustee regarding life insurance trusts, and if so, to what degree?

2. Determine if the findings of the audit/compliance review are consistent with examination findings. If not determine the reasons for any discrepancy.

3. Determine if the trust department is holding any obsolete insurance policies.

4. Review a sample of policies from companies who are bankrupt, in default or have been downgraded by rating services to below investment quality.

5. Ensure that management purchases enough life insurance for the premiums paid.

6. Does management periodically review the client's health to ensure that premiums are not being paid for adverse health ratings?

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**Insurance Products Examination
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Examiner's UITRS Rating, Summary, Conclusions and Recommendations:

References - 870P

Laws

Code of Federal Regulations

| | |
|----------------|---------------------------------------|
| 12 CFR 550.240 | Trust Powers |
| 12 CFR 550.260 | Investment of Funds Held as Fiduciary |
| 12 CFR 563.41 | Transactions With Affiliates |
| 12 CFR 563.42 | Transactions With Affiliates |

Office of Thrift Supervision Publications

Other

Scott on Trusts, 3rd Edition
Bogert and Bogert, Trust and Trustees, 2nd Ed.
Restatement (Second and Third) of Trusts

Workpaper Attachments - 870P

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Insurance Products Examination Program

Optional Topic Questions

The following list of questions is offered merely as a tool and reference for the examiner and is not a required part of the examination process.

Policies and Procedures

| |
|--|
| <ul style="list-style-type: none">• Do the policies and procedures provide investment guidelines for the use of insurance products in discretionary accounts? |
| <ul style="list-style-type: none">• Do the policies and procedures address the criteria used in evaluating insurance companies, such as the rating agencies used and the acceptable ratings? |
| <ul style="list-style-type: none">• Do the policies and procedures address how insurance policies are to be evaluated? |
| <ul style="list-style-type: none">• Do the policies and procedures establish replacement/restructure criteria? |

Acceptance and/or Purchase

| |
|---|
| <ul style="list-style-type: none">• Is the financial stability and performance of the insurance company considered? |
| <ul style="list-style-type: none">• Does management have sufficient expertise regarding insurance products when purchasing or evaluating policies and/or companies? |
| <ul style="list-style-type: none">• Is the anticipated term of the trust considered? |

Annual and/or Periodic Review and Evaluation

| |
|--|
| <ul style="list-style-type: none">• Is an assessment of the life insurance carrier's solvency made? |
| <ul style="list-style-type: none">• Is suitability considered in light of the client's and the trust's objective(s)? |
| <ul style="list-style-type: none">• Has the grantor's medical condition remained the same? |
| <ul style="list-style-type: none">• Has the actual policy performed similarly to the policy illustrations and similar policies of peer companies with regard to dividend, expense and mortality perspective? |
| <ul style="list-style-type: none">• As part of the annual investment review for variable insurance products, is the savings association evaluating the underlying investment securities? |
| <ul style="list-style-type: none">• When appropriate, has the savings association recommended insurance policy restructure/replacement? |
| <ul style="list-style-type: none">• Do reviews comply with 12 C.F.R §§550.200 through 550.220? |

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Introduction to Common and Collective Funds

Funds used for the collective investment of assets are referred to both as common trust funds and collective investment funds. The Internal Revenue Code (IRC) refers to “common trust funds” in §584 while the Office of the Comptroller of the Currency uses the term “collective investment fund” in 12 CFR §9.18. The trust world generally uses the term “common trust fund” to describe funds used for the collective investment of fiduciary accounts. These generally include accounts held by a savings association as trustee, executor, administrator or guardian. Common trust funds are tax-exempt under §584 of the IRC if operated in accordance with the rules and regulations of the Board of Governors of the Federal Reserve System or the Comptroller of the Currency (12 CFR §9.18(a)(1)). The term “collective investment fund” is used primarily to describe the collective investment of tax-qualified retirement plans. Collective investment funds (CIFs) are tax-exempt under Revenue Ruling 81-100. Collective investment funds are also referred to as group trusts and as (a)(2) funds, which references §9.18(a)(2).

The benefit to trust customers of using a common or collective fund as an investment vehicle is the generally favorable investment performance of the funds and a reduction in fees charged to trusts and retirement plan accounts invested in the fund. Another important advantage to participants in a fund is the automatic diversification of investments. The fund is much larger than any of the individual participants investing in the fund. This allows each of the individual trusts or qualified plans to participate in a fully diversified and broadly based investment portfolio. A potential disadvantage is that capital gains (long and short term), and losses are passed through to participants proportionally. Therefore, participants may incur a tax liability resulting from investment transactions within the fund. This, of course, may not be a concern for employee benefit plan accounts or other accounts that are tax-exempt in nature.

Savings associations will be permitted for the first time to offer common and collective funds to its trust customers without having to register them with the Securities and Exchange Commission. This result was achieved by the language in Section 223 of the Gramm-Leach-Bliley Act that amended Section 2(a)(5) of the Investment Company Act of 1940.

OTS Regulation §550.260(a) authorizes savings associations to invest fiduciary funds in CIFs established and administered in accordance with the Comptroller of the Currency’s (OCC) §9.18. There are a number of requirements contained in §9.18. Some of them are described below.

Written Plan

A CIF must be established and maintained in accordance with a written plan. The plan should be approved by a resolution of the bank’s board of directors. The board may assign authority for approving the establishment of a CIF to a designated committee. A plan must contain provisions regarding the operation of the fund, including provisions related to:

- investment powers and policies with respect to the fund;
- allocation of income, profits and losses;
- fees and expenses that will be charged to the fund and to participating accounts;
- terms and conditions governing the admission and withdrawal of participating accounts;

- audits of participating accounts;
- basis and method of valuing assets in the fund;
- expected frequency for income distribution to participating accounts;
- minimum frequency for valuation of fund assets;
- amount of time following a valuation date during which the valuation must be made;
- bases upon which the bank may terminate the fund; and
- any other matters necessary to clearly define the rights of participating accounts.

Fund Management

A savings association administering a CIF shall have exclusive management of the fund. An exception is where a prudent person might delegate responsibilities to others. A savings association should always seek an opinion of counsel as to the securities law consequences of a delegation.

Proportionate Interests

Each participating account in a CIF must have a proportionate interest in all the fund's assets. The accounts investing in the fund are called participants and each participating account shares proportionally in the investment results of the fund. Neither the fiduciary nor any beneficiary of a participating account has ownership of any particular asset or investment of the fund. The interests held in the fund by participating accounts are called units.

Valuation

A savings association administering a CIF shall determine the value of the fund's assets at least once every three months. An exception is made for (a)(2) funds that are primarily invested in real estate or other assets that are not readily marketable. In these cases a savings association shall determine the value of the fund's assets at least once each year. Each fund asset shall be valued at market value as of the date set for valuation, unless the savings association cannot readily ascertain market value, in which case the savings association shall use a fair value determined in good faith. An exception is made for short-term investment funds. A savings association may value a fund's assets on a cost, rather than market value basis for purposes of admissions and withdrawals if the plan requires the savings association to: 1) maintain a dollar-weighted average portfolio maturity of 90 days or less; 2) accrue on a straight-line basis the difference between the costs and anticipated principal receipt on maturity; and 3) hold the fund's assets until maturity under usual circumstances.

Admission and Withdrawal of Accounts

A savings association administering a CIF shall admit an account to or withdraw an account from the fund only on the basis of the valuation described above. An exception would be for (a)(2) funds that are invested primarily in real estate or other assets that are not readily marketable. These funds may require a prior notice period for withdrawals that may not exceed one year.

Method of Distribution

A savings association administering a CIF shall make distributions to accounts withdrawing from the fund in cash, ratably in-kind, a combination of cash and ratably in-kind or in any other manner consistent with applicable law in the state in which the savings association maintains the fund.

Segregation of Investments

If an investment is withdrawn in-kind from a CIF for the benefit of all participants in the fund at the time of the withdrawal but the investment is not distributed ratably in-kind, the savings association shall segregate and administer it for the benefit, ratably, of all participants in the CIF at the time of withdrawal.

Audits and Financial Reports

At least once during each 12 month period, a savings association administering a CIF shall arrange for an audit of the CIF by auditors responsible only to the board of directors of the savings association. At least once during each 12 month period, a savings association administering a CIF shall prepare a financial report of the fund. The report must disclose the fund's fees and expenses in a manner consistent with applicable law in the state in which the savings association maintains the fund. This report must contain a list of investments in the fund showing the cost and current market value of each investment and a statement covering the period after the previous report showing the following (organized by type of investment):

- a summary of purchases (with costs);
- a summary of sales (with profit or loss and any other investment changes);
- income and disbursements; and
- an appropriate notation of any investments in default.

A savings association may include in the financial report a description of the fund's value on previous dates, as well as its income and disbursements during previous accounting periods. A savings association may not publish in the financial report any predictions or representations as to future performance. In addition, with respect to (a)(1) funds, a savings association may not publish the performance of individual funds other than those administered by the savings association or its affiliates. A savings association administering a CIF shall provide a copy of the financial report or shall provide notice that a copy of the report is available upon request without charge to each person who ordinarily would receive a regular periodic accounting with respect to each participating account. The savings association may provide a copy of the financial report to prospective customers. In addition, the savings association shall provide a copy of the report upon request to any person for a reasonable charge.

Advertising Restriction

A savings association may not advertise or publicize any (a)(1) fund except in connection with the advertisement of the general fiduciary service of the savings association.

Self-dealing and Conflicts of Interest

A savings association administering a CIF must comply with the following:

- **Bank Interests.** A savings association administering a CIF may not have an interest in that fund other than in its fiduciary capacity. If, because of a creditor relationship or otherwise, the savings association acquires an interest in a participating account, the participating account must be withdrawn on the next withdrawal date. However, a savings association may invest assets that it holds as fiduciary for its own employees in a CIF.
- **Loans to participating accounts.** A savings association administering a collective investment fund may not make any loan on the security of a participant's interest in the fund. An unsecured advance to a fiduciary account participating in the fund until the time of the next valuation date does not constitute the acquisition of an interest in a participating account by the savings association.
- **Purchases of defaulted investments.** A savings association administering a collective investment fund may purchase for its own account any defaulted investment held by the fund (in lieu of segregating the investment) if, in the judgment of the savings association, the cost of segregating the investment is excessive in light of the market value of the investment. If a savings association elects to purchase a defaulted investment, it shall do so at the greater of market value or the sum of cost and accrued unpaid interest.

Management Fees

A savings association administering a CIF may charge a reasonable fund management fee only if:

- The fee is permitted under applicable law (and complies with fee disclosure requirements, if any) in the state in which the savings association maintains the fund.
- The amount of the fee does not exceed an amount commensurate with the value of legitimate services of tangible benefit to the participating fiduciary accounts that would not have been provided to the accounts were they not invested in the fund.

Expenses

A savings association administering a CIF may charge reasonable expenses incurred in operating the CIF, to the extent not prohibited by applicable law in the state in which the savings association maintains the fund. However, a savings association shall absorb the expenses of establishing or reorganizing a CIF.

Common and Collective Funds Examination Program

Examination Objectives

To determine the adequacy and/or effectiveness of the trust department's administration of common and collective investment funds. Consider whether:

- adequate policies, procedures and internal controls have been established for the administration of common and collective investment funds;
- the funds are operated in accordance with applicable law and the terms of the governing instrument; and
- deficiencies are identified and corrective action promptly initiated.

Examination Procedures

Wkp. Ref.

Level I

Level I procedures first focus on a review of the examination scoping materials. The next step consists of interviews with trust department personnel to confirm their qualifications and levels of expertise; to determine if the trust department's practices conform to written guidelines; to establish whether any significant changes in personnel, operations or business practices have occurred; or whether new products or services have been introduced. If items of concern are uncovered during Level I procedures or if problems are identified during the preexamination monitoring and scoping; the examiner may need to perform certain Level II procedures.

1. Review examination scoping materials related to common and collective investment funds (CIFs). Scoping material should include:
 - Risk profile
 - Relevant PERK documents
 - The fund(s) annual audit(s).
 - Previous trust and asset management examination report
 - Workpapers from the previous examination
 - Plan documentation for each CIF and amendments thereto

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Common and Collective Funds Examination Program

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- Board and committee minutes
 - Examples of CIF marketing material
-
2. Evaluate the adequacy of administrative and operational policies and procedures, as appropriate to the size and character of CIF operations. Note any particular changes. Consider whether the policies address:
- a review of any new CIF plan document by bank counsel;
 - plan approval by the board or a board designated committee;
 - compliance with applicable law and standards of fiduciary conduct; and
 - compliance with the fund's written plan.
-
3. Review the CIF investment policies and procedures for adequacy and appropriateness.
-
4. If an outside investment manager or other portfolio management responsibilities are delegated to a third party, ensure that appropriate documentation is maintained and that compliance with the investment policy is being monitored. Assess the due diligence efforts with respect to the selection of the third party. Assure compliance with OCC regulation 9.18(b)(2), and assess whether any SEC registration issues have been raised as a result of the delegation.
-
5. Determine whether management and staff have the expertise necessary to administer CIF's. Identify and evaluate any personnel and/or organizational changes.
-

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Common and Collective Funds Examination Program

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6. Review procedures for admissions and withdrawals from the CIF. Determine whether anyone has been authorized to review and approve the admissions and withdrawals.
-
7. Review the annual report and audit of each CIF. Determine that the information contained in the financial report meets the requirements of 12 CFR §9.18(b)(6).
-
8. Determine if a copy or notice of the financial report availability is furnished to each person to whom a regular periodic accounting would ordinarily be rendered.
-
9. Determine if the savings association files an informational tax return for the common trust fund with the IRS in accordance with IRC §6032. Determine if the common or collective fund is filing directly with the Department of Labor as a direct filing entity using Form 5500 or whether the CIF is providing participating employee benefit plans with information regarding the underlying assets of the CIF so that the plan may include this information on its Form 5500.
-
10. Consider whether the following risk contributors (if applicable) have been addressed:
- the accuracy and credibility of management reports;
 - the thoroughness of the compliance program;
 - the effectiveness of the supervision and audit function;
 - the quality of the written policies and procedures;
 - the effectiveness of management; and

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- the adequacy of policies and procedures governing the management of CIFs.

The completion of the Level I procedures may provide sufficient information to make a determination that no further examination procedures are necessary. If no determination can be made, proceed to Level II.

Level II

Level II procedures focus on an analysis of trust documents such as reports and outsourcing contracts. The examiner should complete the appropriate Level II procedures when the completion of a Level I procedures does not reveal adequate information on which to base a conclusion that the trust department meets the examination objectives. Neither the Level I nor the Level II procedures include any significant verification.

1. Determine that the savings association maintains exclusive management control of the CIF and that procedures are in place to maintain records relating to investment, administrative and operational decisions in order to document compliance.

2. Determine if sound portfolio diversification principals are followed.

3. If proprietary mutual funds were funded through conversions from the savings association's CIFs, determine whether the savings association considered all pertinent issues before the conversion took place and whether applicable law and fiduciary principles were followed.

4. If there are unresolved exceptions present from internal or external audit reports, compliance reports or examination findings, discuss corrective action with management.

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Common and Collective Funds Examination Program

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5. Review the promotional and advertising publications for the CIF to ensure that funds are marketed only in connection with the advertisement of the general fiduciary service of the savings association.

6. Review the returns of the CIF's and compare the returns to comparable indices for one, three and five year returns. Determine if the returns are reported in accordance with AIMR reporting guidelines. Note any significant differences and discuss with management.

7. Determine if the savings association receives only reasonable compensation for investing ERISA accounts in the collective investment fund. Also determine if the plan document, trust agreement or a fiduciary (other than the savings association or an affiliate) that has authority to manage and control plan assets, expressly permits investment in the fund.

8. If necessary to validate an assertion, finding or concern arising from the completion of the Level I and II procedures, judgmentally select a limited number of accounts for review considering the degree of risk to the institution. Not all types of accounts or funds need to be reviewed to arrive at a well-founded conclusion.

If the examiner cannot rely on the trust and asset management Level I and Level II procedures, or data contained in department records or internal or external audit reports, proceed to Level III.

Level III

Level III procedures include verification procedures that auditors usually perform. Although certain situations may require that Level III procedures be completed, it is not the standard practice of the Office of Thrift Supervision (OTS) examination staff to duplicate or substitute for the testing performed by auditors.

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Common and Collective Funds Examination Program

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1. Review the management and administration of the CIFs. Determine if management is following internal procedures and is in compliance with the terms of the written plan governing each of the CIFs.

2. If the CIF obtains its tax-exempt status under IRC §584, determine that it is operated in conformity with 12 CFR §9.18.

3. For any defaulted securities (equity or fixed) held by a CIF, determine if the security(s) have been segregated in a separate account on the annual report.

4. Review expenses and charges to the CIF. Ensure that all charges to the funds are appropriate and authorized by applicable law.

5. Review a sample of portfolio valuations. Determine that the valuations are:
 - completed at least quarterly (except funds invested primarily in real estate or other not readily marketable assets) and in accordance with the frequency set forth in the plan; and
 - in conformance with the express methodology provisions of the plan.

6. Review a list of participants in each CIF to ensure that only eligible accountholders are allowed to participate. Ensure that IRA and Keogh accounts are not invested in common trust funds per SEC no-action letters.

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7. Review a sample of investment portfolios to determine compliance with terms of the saving association's investment policy. Identify any significant changes in holdings, credit quality or risk profile.
-
8. Ensure that current plan documentation for each CIF operated by the trust department is on file. Review documents for each new CIF and amendments to existing CIF's for compliance with 12 CFR §9.18(b)(1). For new CIFs, review the IRS determination letter for tax- exempt status if one has been issued.
-
9. Ensure that admissions and withdrawals are performed according to policy and are posted in a timely manner.
-
10. If the savings association converted an ERISA collective investment fund into a proprietary mutual fund, determine if the conditions of prohibited transaction class exemption PTE 97-41 were met.
-
11. Determine if the following conditions of PTE 91-38 have been met:
- The plans interest in a CTF does not exceed 10 percent of the total assets unless it is a STIF
 - The terms of purchases and sales (or any other transactions) by the CTF are at least as favorable to the CTF as those obtainable in an arm's length transaction with an unrelated party
 - The savings association is maintaining CTF records for six years from the date of any of the above referenced transactions
-

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12. Select a sample of short-term investment funds (STIF's) and determine whether such funds are operated in accordance with the provisions of 12 CFR §9.18.
-

Examiner's UITRS Rating, Summary, Conclusions and Recommendations:

References - 880P

Laws

Internal Revenue Code Section 584

Code of Federal Regulations

| | |
|-------------------|---|
| 12 CFR 550.240 | Trust Powers |
| 12 CFR 550.260(b) | Investment in Collective Investment Funds |
| 12 CFR 550.40 | Investment Authority |
| 12 CFR 9.18 | Collective Investment Fund Regulation |

Office of Thrift Supervision Publications

Other

Revenue Ruling 81-100

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Common and Collective Funds Examination Program

Optional Topic Questions

The following list of questions is offered merely as a tool and reference for the examiner and is not a required part of the examination process.

Plan Documentation

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| <ul style="list-style-type: none">▪ Does the plan set forth written provisions addressing the following:<ul style="list-style-type: none">• Investment powers and policies?• Fees and expenses to be charged to the fund?• Terms and conditions governing the admission and withdrawal of participating accounts?• Audits of the fund?• Bases upon which the savings association may terminate the fund?• Any other matters necessary to clearly define the rights of participating accounts? |
| <ul style="list-style-type: none">▪ Is a copy of the plan available to any person for inspection at the offices of the savings association during business hours and is a copy provided to any person who requests it? |

Annual Report

| |
|---|
| <ul style="list-style-type: none">▪ Does the annual report list the fund's investments, showing both book value and market value? |
| <ul style="list-style-type: none">▪ Does the annual report list purchases and sales, showing any profits and losses for the period? |
| <ul style="list-style-type: none">▪ Does the annual report provide a statement of income and disbursements for the period? |
| <ul style="list-style-type: none">▪ Does the annual report provide a notation of any investments in default? |
| <ul style="list-style-type: none">▪ Does the financial report only include representation regarding the fund's value on previous dates and income and disbursements during previous accounting periods and make no predictions or representations as to future performance? |
| <ul style="list-style-type: none">▪ Does the financial report only reference the performance of funds administered by the savings association or affiliates? |
| <ul style="list-style-type: none">▪ If the financial report includes any comparative performance statistics, are they made in conformance with AIMR guidelines? |

Investment Portfolio

| |
|--|
| <ul style="list-style-type: none">▪ Do the investments held by the fund correspond with the investment objectives of the participating accounts and the authorized investments for each participating account? |
| <ul style="list-style-type: none">▪ For any defaulted securities, is the purchase by the savings association undertaken in conformance with the guidelines noted in 12 CFR §9.18(b)(8)(ii)? |
| <ul style="list-style-type: none">▪ Are brokerage transactions for CIFs placed on the basis of best execution? |

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Common and Collective Funds Examination Program

- | |
|---|
| <ul style="list-style-type: none">▪ Are decisions to purchase, sell or retain investments for the CIF fully documented? |
|---|

Portfolio Diversification

- | |
|--|
| <ul style="list-style-type: none">▪ Do any participating accounts hold a substantial percentage of the units of the CIF? |
| <ul style="list-style-type: none">▪ Does any single holding of stocks, bonds or other obligations, not guaranteed by the U.S. government, of any one entity constitute a significant percentage of the entire holdings of the CIF? |
| <ul style="list-style-type: none">▪ Does the savings association maintain, in cash and/or readily marketable securities, a sufficient percentage of the assets of the fund as necessary to provide for liquidity needs and to prevent inequities among withdrawing participants? |

Admissions and Withdrawals

- | |
|---|
| <ul style="list-style-type: none">▪ Are admissions and withdrawals permitted only if a written request or notice of intention is entered in the CIFs records on or before the valuation date? |
| <ul style="list-style-type: none">▪ Are admissions and withdrawals permitted only in the manner prescribed by written plan of the CIF? |
| <ul style="list-style-type: none">▪ Are distributions to withdrawing participants made in cash or ratably in kind, or partly in each or in any other manner consistent with applicable state law? |

Prohibited Transactions

- | |
|--|
| <ul style="list-style-type: none">▪ Did the savings association sell assets to or purchase assets from a CIF (excluding defaulted securities)? |
| <ul style="list-style-type: none">▪ Did the CIF invest in stock or other obligations of the savings association or its affiliates? |
| <ul style="list-style-type: none">▪ Did the savings association make loans on the security of a participation in a CIF? |
| <ul style="list-style-type: none">▪ Did the CIF borrow funds from any source? |

Advertising

- | |
|---|
| <ul style="list-style-type: none">▪ Did the savings association refrain from advertising or publicizing the CIFs except in connection with the advertisement of the general fiduciary services of the bank. |
|---|

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