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 different 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.

- ***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