

**Introduction to Earnings**

The Uniform Interagency Trust Ratings System (UITRS) requires trust and asset management earnings to be evaluated at all financial institutions, including savings associations, however an assignment of an earnings rating is required only for institutions that, at the time of the examination, have total trust assets of more than \$100 million or engage solely in trust and asset management activities (regardless of the volume of assets administered). For institutions where the assignment of an earnings rating is not required by the UITRS, each federal banking agency has the option of assigning an earnings rating using an alternate set of ratings. See Section 060 for more details.

The earnings rating will reflect the profitability of a savings association's trust and asset management activities and its effect on the financial condition of the institution. In determining the rating, the use and adequacy of budgets and earnings projections by function, product line and client are reviewed and evaluated. Risk exposure that may lead to negative earnings is also evaluated. In evaluating earnings, emphasis should be placed not only on existing levels of profitability but also on recent earnings trends, the department's new business efforts and competitive factors to determine whether current earning trends are likely to continue. For example, a department that is currently unprofitable but has substantially narrowed its losses in the past several years should not be viewed the same as one that continues to operate at the same general loss level year after year.

Each savings association providing trust and asset management services should have a short and long-term business plan that includes those activities. Such a plan will help communicate the institution's goals, objectives and expectations to all personnel. An essential element in a successful business plan is a marketing strategy that will identify new or expanded business lines and products as well as where the savings association will concentrate its new business efforts. Care must be taken, however, to ensure that the institution has the expertise, staff and facilities to satisfactorily manage the anticipated growth and expansion.

Profitability and business trends of existing products and services should be well known to management and should be regularly compared to the institution's earnings projections. Significant deviations between planned and actual results may be a symptom of a poor planning process, poor execution of the plan, unforeseen business or economic conditions, improper mix of employee resources or a combination of all of these factors. Each savings association should be encouraged to develop objectives related to the trust department's level of profitability and to measure both direct and indirect income and expenses. Management should use income and expense results as a basis for determining which services it might want to discontinue, whether fees should be adjusted and which types of accounts should be emphasized in new business development efforts.

Examiners should review an institution's new business development efforts. Such review should include management's evaluation of the risks inherent in new business areas, an assessment of available expertise and capabilities, and the institution's ability to establish the appropriate internal controls for any new products or services. Examiners should also review the savings association's marketing plan for completeness and reasonableness. While no one approach will suit every institution and market area, there are common areas that examiners should expect to see in any marketing plan:

- A definition of the market area for trust and asset management services (which may differ from the market identified for commercial and retail banking products).
- The characteristics of the market area, including demographics, geographic or legal impediments (there may be difficulties in marketing some products in an adjoining state). Existing trust and asset management competition should be identified and considered in estimating the growth potential of various products.
- Sources of new business (existing bank customers, new customers based on demographics, and professional referrals).
- The means of generating new business, such as cross-marketing efforts, hiring of business development staff, the hiring of sales personnel and the use of internal incentive programs.

Management of the savings association, subject to the oversight of the board, should develop business and marketing plans consistent with the approved level of risk that the institution is willing to assume. Virtually any savings association can increase its volume of new business by relaxing its standards. However, if the institution relaxes acceptance standards too much, the level of risk assumed might be beyond what the board of directors has approved and what is prudent. This situation may warrant significant examiner criticism and prompt resolution. Therefore, in the examiner's review of the planning and budgeting process, there should be an eye toward the concept of "risk adjusted return." This is the return that the savings association generates in the trust and asset management business relative to the risks it assumes in the operation.

Profitability is determined through a review of a department's financial statement. However, profitability is not necessarily an end in itself. Among the factors that should be evaluated along with existing levels of profitability or losses are:

- The emphasis placed by senior management on profitability, in terms of establishing objectives and monitoring results.
- The size and geographic location of both the savings association and its trust department. The size may impose natural limitations on absolute levels of profitability or geographic location may dictate the level of competition for trust and asset management services.
- Special circumstances such as market declines.
- Unusual features or circumstances regarding composition of business, fee schedules, charge-offs or other compromise actions.
- The extent to which the savings association views its trust department as an ancillary offering to accommodate customers of other departments.

## **Income and Expenses**

Fees and other direct income of a savings association are measured by using either the accrual or cash method of accounting. Fees charged to trust and asset management accounts are usually the primary component of trust department income. They are often based on the size of the account, but may take into consideration the type and complexity of assets under management, the volume of transactions in the account, the customer's total relationship with the savings association and other factors. Indirect income is not routinely measured or tracked, but recently with an increased reliance on indirect income such as shareholder servicing fees, it has become more prevalent. One indirect income item commonly seen is an internal credit for commercial deposits. Both demand and interest-bearing deposits should be included in the

calculation. The availability and use of automated sweep systems for the overnight investment of previously uninvestable funds has minimized the level of idle demand deposits and the credit for them.

Department expenses, which are generally categorized as direct or indirect include such items as salaries, benefits, data processing costs, auditing costs, marketing costs and insurance premiums. Direct expenses are those incurred directly by the trust and asset management function, such as the salaries of trust department employees, typically the largest expense to the function. Indirect (or allocated) expenses include those incurred by other parts of the institution in support of trust and asset management activities. They also include those incurred for general savings association activities for which the trust and asset management function may be assessed a pro-rata share of the cost, such as the institution's audit program or occupancy based on allocated floor space. Some expenses may be incurred on both a direct and an allocated basis.

In larger departments, a cost accounting system may provide the means of measuring trust and asset management profitability. Some systems can measure costs by product line, type of account, individual administrator, type of transaction or other areas or functions within the department. An effective cost accounting system can also help establish a pricing schedule based upon services provided, the time required to provide the service or execute a transaction, the number of transactions processed, a valuation of assets and other variables. Even in small departments, the major expense category, salaries, can be estimated by determining the percentage of each staff member's time devoted to trust and asset management activities. In the same way, employee benefit expenses can be allocated to the trust department by taking the total amount of benefits for the savings association and dividing it by total salaries. This percentage can then be applied against the trust department salary figure already determined. Data processing and auditing costs can often be identified or easily allocated to the trust department. Examiners should review management's methods of allocating costs for reasonableness, particularly when shared with an affiliate.

### **Referral or Finders Fees**

Many trust departments adopt a fee payment system for the purpose of enhancing their marketing efforts. These fees are commonly referred to as referral or finders fees. Typically, the payment of a referral fee is a percentage of the trust and asset management fee charged to the customer. In some cases, this fee can represent a substantial portion of the overall income received for administering an account, thus reducing the ability of the trust department to operate profitably. Nevertheless, management may see this as a necessary expense in order to generate new business within the institution's customer base or penetrate a new or otherwise unavailable market. Examiners should ensure that management has supported its decision to pay referral fees by establishing written policies governing the activity and formal agreements with referring parties, as appropriate. Formal agreements are particularly important when dealing with affiliates and other third-parties referring business to the trust function. Management should regularly assess the impact of all referral payments on the department's profitability. On September 5, 2000 OTS released formal guidance in the form of Thrift Bulletin 76-1, regarding the payment of referral fees.

### **Losses**

Nonrecurring expenses must be addressed in any review of profitability. Persistent expenses of this type may be an indication of underlying account problems or management weaknesses. These losses may be attributable to:

- Settlements - the formal and informal agreements to reimburse trust accounts or others that are reached without the decree of a court;

- Surcharges - amounts required by court decree to pay to trust accounts or others, normally because of negligence or other failure of duty; or
- Other situations such as defalcations, lost or stolen securities, fee waivers and uncollectible fees, interest and penalties paid due to tax errors, account reimbursements and civil money penalties imposed by regulatory agencies.

In analyzing these types of expenses, examiners should recognize that the gross amount of the loss might be offset by insurance coverage or may be recoverable from other parties. Trust profitability systems may treat these nonrecurring expenses either on a gross or net basis. On a gross basis, the entire amount of the loss would be reported as an expense and any recovery may be considered an income item. On a net basis, insurance proceeds or other recovered funds are netted against the loss, with only the net figure reflected. Either approach is satisfactory if applied on a consistent basis.

### **Budgeting and Strategic Planning**

Realistic budgets are encouraged for all trust and asset management operations. Budgets should be established and periodically reviewed by management, with significant deviations of actual performance from budget expectations brought to the attention of senior management. Examiners should understand and evaluate a savings association's budget and its policy regarding operating performance and prospects. Management should also attempt to establish at least a three-year projection of financial results, in accordance with the savings association's overall business plan and the trust department's marketing plans. In situations where there is no budget or clear policy or understanding of these matters, or where there is inadequate recordkeeping, the examiner should make appropriate comments and recommendations to management.

### **Reporting**

**FFIEC 001:** All institutions with total fiduciary assets of \$100 million or more, and all nondeposit trust companies that are subsidiaries of federal financial institutions are required to complete an annual Fiduciary Income Statement. The information is to be provided in the format prescribed by Schedule E of the Annual Report of Trust Assets, FFIEC 001. NOTE - beginning in 2001 this form is no longer required.

**OTS Quarterly Thrift Financial Report (TFR):** All OTS regulated institutions are required to report trust department financial information on the quarterly TFR. As of June 2000, trust department activity is reported on the Supplemental Information page, line 350. Beginning in the first quarter of 2002, more comprehensive reporting of trust and asset management activities will be required.

**Other:** Trust departments may have financial reporting requirements to other regulators including state banking authorities or the Securities and Exchange Commission (SEC).

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# Earnings Examination Program

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## Examination Objectives

To determine whether:

- the savings association's procedures for monitoring the trust department's income and expenses, relative to the size and scope of its trust and asset management activities and their importance to the institution, are adequate and effective;
- the savings association's supports growth and new business development; and
- the frequency and scope of profitability reviews and planning by the board of directors and senior management is adequate.

## 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 income, expenses and profitability of the trust department. Scoping materials should include:
  - Risk profile
  - Relevant PERK documents
  - Three year UTPR
  - ECEF reports
  - Previous trust and asset management examination report

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- Previous safety and soundness examination report
  - Workpapers from the previous examination
  - Management financial reports
  - Board and committee minutes
  - Current fee schedule
  - Referral fee agreements
  - Employee commission arrangements
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2. Review the board of directors' minutes for discussions related to the financial aspects of trust and asset management activities.  

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3. Review losses, charge-offs, settlements and other similar financial activities since the previous examination and evaluate for recurring patterns or unusual trends. Review any ongoing litigation for potential impact on earnings.  

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4. Evaluate the savings association's financial condition with regard to its trust and asset management activities. Note and evaluate any significant or unusual fluctuations in the year-to-date and past three fiscal year financial statements.  

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5. Assess the trust department's new business and marketing plans and determine if there are any significant changes since the last examination. If so, has management considered the impact of these changes on the growth and earnings of the trust department and the savings association?  

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6. Assess management's review of fees, expenses and related items.
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7. Review the trust department's current budget.
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8. Consider whether management has addressed the following factors in relation to financial and strategic risk:
- the level of current income and expenses are meeting management's expectations;
  - the business planning and budgeting processes for trust and asset management activities are sufficient;
  - appropriate provisions have been made for future trust and asset management products and services, including such factors as new business development goals, reasonable profit expectations, reasonable market penetration objectives and potential management or staffing changes;
  - undue reliance is not being placed on nonrecurring fees; and
  - charge-offs and other settlement actions that may adversely affect projected income, expenses and capital, particularly if they are recurring.
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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.**

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### 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.

1. Compare the trust department budget to actual operations and identify any material variances. Determine if the budget is realistic and has management's support.

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2. Review any account receivables over 60 days past due. Determine if this has been a recurring problem. Discuss the collection policy with management.

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3. Determine if there are numerous deviations from the standard fee schedule. If so, discuss the fee waiver policy with management.

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4. Review referral fee and commission arrangements. Determine their impact on earnings.

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5. Determine the accuracy of the FFIEC Form 001 and the quarterly TFR regarding the reporting of trust department assets.

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6. Determine if management has a plan for handling customer complaints.

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**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.**

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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. Evaluate the income statement and determine if excessive revenue is being passed on to an affiliate or other third party.  

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2. Evaluate the expense report and determine if there are excessive expenses being charged by an affiliate or other third party.  

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3. If the trust department experiences significant internal issues and/or risks that threaten the viability of the institution, discuss strategic turnaround plans with management and determine whether the board of directors has been advised.  

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4. Determine if management has a plan for personnel replacement.  

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5. Determine if a capital plan should be developed.  

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6. Determine if management should develop a loss reserve.  

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7. As appropriate, discuss the long-term viability of the trust department with management in light of continuing losses and the risks they may pose to the institution. Has the board considered transferring the trust accounts and relinquishing its trust charter.  

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

**References - 610P**

None

**Workpaper Attachments - 610P**

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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"><li>• Has a procedure for pricing trust and asset management services been established and has a fee schedule been committed to writing?</li></ul>
<ul style="list-style-type: none"><li>• Does management periodically review the fee schedule to address the continued reasonableness of fees in relation to the services provided?</li></ul>
<ul style="list-style-type: none"><li>• Does a designated committee or person approve deviations from the fee schedule and is the reason for the deviation documented?</li></ul>
<ul style="list-style-type: none"><li>• Does the board or a designated committee review profitability at least annually?</li></ul>
<ul style="list-style-type: none"><li>• Does the profitability review consider deviations from budgets and salaries?</li></ul>
<ul style="list-style-type: none"><li>• Does the internal allocation process for certain expenses appear reasonable?</li></ul>
<ul style="list-style-type: none"><li>• Are there any unusual circumstances that have a significant negative effect on profitability, such as numerous fee waivers, unusual expense items or unprofitable product lines?</li></ul>
<ul style="list-style-type: none"><li>• Does management review losses, charge offs and settlements and their effect on profitability?</li></ul>

### ***Business Plan***

<ul style="list-style-type: none"><li>• Does the savings association's business plan include short and long term goals for trust and asset management activities?</li></ul>
<ul style="list-style-type: none"><li>• Prior to expanding a product line or demographic area, does the business plan consider staffing and other costs?</li></ul>
<ul style="list-style-type: none"><li>• Are provisions in place for developing new sources of business and services?</li></ul>
<ul style="list-style-type: none"><li>• Does the plan consider marketing and advertising?</li></ul>
<ul style="list-style-type: none"><li>• Does the plan consider the trust department's strengths and weaknesses as well as the competitive environment?</li></ul>

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