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This document and any attachments are superseded by Comptroller's Handbook - Community Bank Supervision.

Background

This section describes the philosophy and methods used by the Office of Thrift Supervision to supervise the trust and asset management activities of OTS regulated savings associations. The supervisory process must be as dynamic as the industry itself. The process should evaluate the savings association's ability to proactively identify, measure, monitor and control the risks inherent within the trust and asset management business. The supervisory process should also ensure adherence to the basic fiduciary concepts of prudent account administration, investment management and the duty of undivided loyalty.

The trust and asset management industry has experienced many changes in both the nature and complexity of these activities. The industry has become growth oriented and highly competitive. It has also been impacted by demographic, technological, regulatory and global economic trends in the past quarter century. Notable characteristics of the industry's evolution include:

- fee income becoming a significant contributor to a financial institution's profits;
- industry consolidation through mergers and acquisitions;
- competition from all financial service providers such as banks, investment companies, insurance companies and brokerage firms;
- shift from defined benefit plans to defined contribution plans and IRA's;
- development of complex and rapidly changing products, services and delivery technologies; and
- increased sophistication and litigation tendencies of the customer base.

Terminology used within the industry has changed considerably. Many years ago the use of the term "the trust business" denoted instances in which a bank or savings association was acting as a fiduciary. Today, a reference to the trust business increasingly signifies an institution providing trust and asset management services. The term "asset management" is used by the industry and throughout this handbook to mean the management of third-party assets for a fee or commission. Trust and asset management thus includes the provision of fiduciary services (personal, employee benefit, corporate and investment advisory services) as well as agency arrangements including custody of assets. All these trust and asset management services are provided through various distribution channels that depend upon the size, complexity and geographic characteristics of the trust department. For ease of reference, the term "trust department" is used in this handbook to refer to trust and asset management activities conducted within the savings association, a service corporation, an affiliate or an operating subsidiary.

As a result of the many changes in the industry, institutions are exposed to broader and evolving risks, which reinforce the importance of maintaining sound risk management processes. The OTS will continue to emphasize the importance for savings associations to identify, measure, monitor and control all risks associated with their trust and asset management activities. Strong risk controls and monitoring systems are essential to ensure effective management of risk exposures across all geographies, legal entities, products and services.

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Introduction

The trust and asset management business presents varied and unique risks to a savings association and therefore warrants a risk oriented supervisory approach. Under this approach examiners do not attempt to prohibit risk taking, but rather, attempt to ensure that the management and directors of the savings association understand and control the levels and types of risk they assume. As an organization grows more diverse and complex, risk management must keep pace. When risk is not properly managed, the OTS examination process will direct management to take corrective action.

The supervision by risk concept is a “top-down” approach that focuses on the process and methodology used by the trust department to identify, measure, monitor and control risks. This concept allocates greater resources to those areas with higher risks. The supervision by risk concept is achieved by using common definitions to identify risk, common methods of evaluation to measure risk and an overall evaluation of risk management to determine whether systems adequately manage and control existing levels of risk. The objectives of the supervision by risk concept are to:

- determine the condition of the savings association’s trust and asset management activities and the risks associated with current and proposed activities, including risks originating in operating subsidiaries, service corporations and affiliates.
- determine whether management has effectively identified risks within its trust and asset management activities.
- evaluate the overall integrity and effectiveness of risk management systems, using periodic validation techniques to verify accuracy.
- ensure adherence to applicable law and sound fiduciary principles.
- communicate findings, recommendations and requirements to directors and senior management in a clear and timely manner and obtain commitments to correct significant deficiencies.
- verify the effectiveness of corrective actions or if actions have not been satisfactorily accomplished, pursue resolution through more aggressive supervision or enforcement actions.
- pursue continuous off-sight monitoring to assess the impact of internal and external changes on the trust department.

A properly executed supervision by risk concept results in a risk-focused examination methodology that will generate a risk profile for each savings association; cause a review of the risk identification, measurement, monitoring and control processes used by the savings association; ensure compliance with applicable law and sound fiduciary principals; and utilize resources effectively.

Concept and Components

The success of the supervision by risk concept will require the examiner to have comprehensive knowledge of the specific savings association and the overall industry. Since the scope of any supervisory activity will be determined based upon an assessment of risks, the examiner should have current and thorough information regarding the trust and asset management activities of the savings association. Such information can be gathered through review of prior examination reports and workpapers; strategic plans and budgets; internal management reports; board of directors packages; meeting minutes; press releases; published news stories; and discussions with trust department personnel.

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The examiner should also determine the quantity of risk present and assess the quality of risk management. This practice is also used for determining the scope of examination (level I, II or III) in the trust and asset management examination process as detailed in the individual examination programs of this handbook. A well-executed internal risk management system (including a strong audit and compliance function) would likely reduce the examination level in the examination process.

There are various types of risk inherent in each trust and asset management activity, broadly identified as: reputation; strategic; transaction/operational; compliance/legal; and financial risk. These risks are therefore present in each savings association engaged in trust and asset management activities. After a determination as to the types and quantity of risk present, the examiner should assess the savings association's process for identifying, measuring, monitoring and controlling such risks. When assessing the quality of risk management, the examiner should consider board and senior management oversight; policies, procedures and practices; management information systems and controls; and audit, compliance and risk management functions. Factors to consider and address include:

- Quantity of risk: (High, Medium, Low)
- Quality of risk management: (Effective, Acceptable, Weak)
- Direction of risk: (Increasing, Stable, Decreasing)

Once the overall integrity of the savings association's oversight system is verified, conclusions as to the quantity and direction of risk may be made based upon the institution's own assessment of those risks rather than the need for the examiner to perform extensive transaction testing. If on the other hand, the savings association's process appears to be inadequate or nonexistent, transaction testing may be necessary.

Risk Definitions

The definition of risk associated with trust and asset management activities will be a compilation of the many risks associated with the business. These risks are outlined below. Although each risk will be reviewed individually, they are all interrelated and therefore need to be viewed as such.

Reputation Risk: This is the risk to the savings association's earnings and capital arising from negative public opinion. Negative publicity (often the result of lawsuits) can be caused by many factors, including failure to address and manage the other risks identified below. Increased reputation risk can affect the savings association's ability to establish appropriate customer relationships and/or service existing relationships. Failure to properly monitor all risks will subject the savings association to litigation and financial loss.

Strategic Risk: This is the risk to the savings association's earnings and capital arising from improper business planning; poor decision-making and failure to implement decisions; or inadequate responses to changes in the industry. This risk focuses on the savings association's ability to develop sound business strategic goals and deploy appropriate resources to achieve them. The savings association's strategy should be developed using an analysis focusing on its strengths, weaknesses and opportunities.

Transaction/Operational Risk: This is the risk to the savings association's earnings and capital arising from the inability to perform certain agreed upon functions in the delivery of a trust product or service, as well as the oversight of information and technology. Transaction risk is evident in each product and service offered.

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Compliance/Legal Risk: This is the risk to the savings association's earnings and capital arising from noncompliance with applicable laws and sound fiduciary principles, internal policies and procedures or ethical standards. This risk exposes the savings association to potentially increased legal costs, fines, civil money penalties and surcharges. More importantly however, the savings association's reputation is also negatively impacted, thereby affecting franchise value and increased business opportunities.

Financial Risks: There are several subsets of financial risk that are inherent in fiduciary activities where the financial institution has discretion over account assets or provides investment advisory services for a fee. Each individual discretionary account may present one or more of the subsets of financial risk.

- *Credit Risk*: This is the risk to the value of the fiduciary account portfolio arising from an obligor's failure to meet the terms of any contract. Credit risk is found in all activities where success depends on the counterparty, issuer of a security or borrower [illegible]. (Example: Fiduciary decides to invest in a corporate fixed income obligation in order to generate income for account. The issuer/obligor fails to pay interest and/or principal, creating a default. The income generation objective of the account has been violated by the inability of the obligor to pay. This account was adversely impacted by credit risk).
- *Price Risk*: This is the risk to the value of the fiduciary account portfolio arising from changes in the market value of traded financial instruments.
- *Liquidity Risk*: This is the risk to the value of the fiduciary account portfolio arising from the account's inability to meet obligations and achieve account objectives. Liquidity risk includes the inability to manage unplanned decreases in account assets. (Example: Fiduciary decides to purchase securities for account portfolio that for some reason decline in value or are limited in marketability. Account objectives require that adequate liquidity be maintained to achieve a stated goal, such as generating income. Due to the lack of liquidity in account assets, a stated account objective may not be achieved or the value of the account may be negatively impacted).
- *Interest Rate Risk*: This is the risk to the value of the fiduciary account portfolio arising from movements in interest rates. (Example: Fiduciary decides to invest in a corporate fixed income obligation in order to generate income for the account. The decision to purchase such a security was based upon the current interest rate environment and the yield being provided by the investment. Due to an increase in interest rates, the yield on the account investment decreases. This account is then adversely impacted by interest rate risk).
- *Foreign Exchange Risk*: This is the risk that movements in exchange rates may adversely affect the value of a fiduciary account's holdings. Since foreign-exchange rates can be subject to large and sudden swings, strong management expertise is needed to understand and manage the risk associated with exchange-rate volatility.

The earnings and capital of savings associations with significant reliance on trust and asset management revenues may be adversely affected when financial markets experience a significant and sustained downturn. Since trust departments are dependent on transaction volumes and market values of assets under management; revenue and hence earnings, may decline substantially during periods of adverse market movements. Savings associations could ultimately find themselves funding trust department capital when unfavorable market conditions exist.

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Supervision Process

Supervision by risk is a dynamic process and involves four basic areas.

Planning: Planning begins with a careful and thorough assessment of the savings association's current and anticipated risks. Effective and periodic communication with management is also necessary in this process. Supervisory strategies must be developed prior to any activity and should incorporate the information known about the savings association as well as industry, economic, legislative and regulatory developments. Supervisory strategies direct examination priorities.

Examining: The on-sight examination assesses the savings association's condition, establishes correction of significant deficiencies and identifies activities to be monitored off-sight. Through a formal examination, examiners gain a fundamental understanding of the condition of the trust department, the quality of management and control provided by risk management systems. When possible, examiners should rely on the savings association's internal systems, including its external and internal audits, compliance functions and risk management systems. These systems may need to be periodically tested and validated for integrity and reliability. The examiner conducts the review by following examination programs that include: management, operations, controls and audits, earnings, compliance and asset administration (MOECA).

Sampling/Testing: Historically, choosing a representative sample of trust accounts, assets or activities to be reviewed during an examination has been one of the first things on the examiner's agenda. For example, in the past, samples have been chosen before ever talking with management; looking at the savings association's policies, procedures and controls; or reviewing audit reports. Likewise, the sampled items have often been reviewed in detail even though past examinations and recent audit reports indicated no concerns; excellent controls; established safeguards and management; and staff remain qualified and stable. In the risk focused examination process, a distinction is drawn between exception based sampling and the risk focused selection of a few accounts or assets merely to verify that policies or procedures are working as reported; to clarify a policy or process; or to actually see how a particular situation is handled. The basic premise of the risk focused examination is that sampling is done **<u>"as necessary"</u>**, not automatically.

This is not to say that at any time during the examination process the examiner cannot look at a couple of accounts, assets or an activity in order to get a better feel for a process; better understand the implementation of a new policy or product; or confirm an assertion made by management or the auditors. That would not be unusual during any examination but the review should be limited in scope and directed to a specific question or situation.

Sampling and testing of accounts, assets and activities has a place in, and remains an integral part of, the examination process, however it is used in a little different context in the risk focused examination world. The automatic starting point for each examination should not be sampling and testing.

Communication: Off-sight monitoring and onsite trust and asset management examinations are discussed with and reported to senior management and the board of directors. Corrective action is recommended and a monitoring process is implemented to ensure management is establishing appropriate controls in the risk management system.

The supervision by risk process is continuous. Onsite examinations simply supplement the process. Monitoring includes periodic communication with the management of the trust department, as well as reviewing financial and account information submitted to OTS. Identification of higher risk areas within an savings association, which can also be affected by the external (e.g., economic) environment should

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determine the level of oversight between examinations, the frequency of onsite examinations and the level of onsite examinations.

<u>As a general rule:</u>

Associations rated “1” would receive alternating regular and targeted examinations at 24 month intervals.

Associations rated “2” would receive a regular examination on a 24 month interval.

Associations rated “3” and “4” should receive a regular examination on a 12 month interval.

Associations rated “5” should receive a regular examination on at least a [illegible] month interval.

Associations with trust assets totaling more than $1 billion should receive a regular examination on a 12-month interval.

These guidelines above are minimums. Regular examinations may be conducted on a shorter cycle or supplemented with targeted examinations as needed. As noted previously, the supervision by risk process should be continuous. Examination schedules should be flexible and guided by the identification and monitoring of higher risk areas within an individual savings association.