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 that 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 distribution of the securities. In order to meet these objectives 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 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

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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.

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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 polices 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

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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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- 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 Program

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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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 the policies reviewed and approved by the board of directors?
• Is there sufficient knowledge and expertise available to properly and prudently administer these assets?
• Do the policies address the purchase, sale and retention of the following types of miscellaneous assets: • 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

• 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?
• When these assets are received (either in kind or by purchase), does the department take such steps as are necessary to establish ownership?
• Is the decision to purchase, retain or sell consistent with the needs and objectives of the individual account?
• 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:
• Provisions of the governing instruments?
• Acceptability and marketability of collateral?

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• Collateral value to loan ratio?
• Credit worthiness of the borrower?

Administration of loans

Are the following practices and procedures in place:
• Tickler systems adequate to assure prompt payment.
• Procedures adequate to address the handling of delinquent loans. Are they followed?
• Is collateral subject to periodic valuation, appraisal or inspection?
• Is there sufficient collateral value to protect the savings association's interest?
• 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:
• Proper control, storage, authentication and insurance?
• Appraisals or valuations conducted periodically or when necessary?

Management of worthless securities

Are the following practices and procedures in place:
• The savings association has taken reasonable steps to ascertain the value of such securities?
• 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:
• Steps for determining whether the investment is in accordance with applicable law?
• Dollar volume, position limits or other restrictions and limitations of the investment for particular accounts?
• Methods of reporting and approving the transaction?
• Accounting and record keeping practices?
• Auditing and other internal control safeguards?

Other

• Are any restricted securities administered in accordance with SEC Rule 144?

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• Are investments in private placements analyzed and evaluated in accordance with the given restrictions?
• 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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