Trust Examination Manual

Section 3 - Asset Management - Part I
Investment Principles, Policies and Products

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A. Trust Investment Principles

The management of property for others is one of the principal functions of a fiduciary. Fiduciaries administering personal or corporate accounts, either as trustee or agent, are guided by state statutes and the principles embodied in common law. For employee benefit accounts, ERISA, with its implementing Department of Labor (DOL) regulations and opinions, provides statutory and regulatory guidance.

The primary investment guidance given to fiduciaries is found in the terms of each account's governing instrument. There are major differences in the fiduciary's responsibilities under different types of accounts.

- When the fiduciary has discretion to select investments for an account, or makes recommendations for the selection of investments, the investments selected must both follow the terms of the governing instrument and be suitable investments given the needs of the beneficiaries or the purpose of the trust.

- When the trust department has no discretion in choosing investments (such as for self-directed or custodial accounts), the institution's sole responsibility is to follow the provisions of the governing account instrument.

Accounts subject to ERISA, diversification standards, parties in interest, and co-fiduciaries and investment managers are presented in Sections 404 through 406. Refer to specific sections of ERISA in Appendix E - Statute 404 through 406 and Section 5 of this Manual for further discussion.

B. Suitability

In enacting the Prudent Investor Act, states should have repealed legal list statutes, which specified permissible investments types. (However, guardianship and conservatorship accounts generally remain limited by specific state law.) In those states which adopted part or all of the Prudent Investor Act, investments must be chosen based on their suitability for each account's beneficiaries or, as appropriate, the customer. Although specific criteria for determining "suitability" does not exist, it is generally acknowledged, that the following items should be considered as they pertain to account beneficiaries:

- financial situation;
- current investment portfolio;
- need for income;
- tax status and bracket;
- investment objective; and
- risk tolerance.

C. Prudent Investments

There are two fiduciary standards governing the prudence of the individual investments selected by a fiduciary: the Prudent Investor Act and the Prudent Man Rule. The Prudent Investor Act, which was adopted in 1990 by the American Law Institute's Third Restatement of the Law of Trusts ("Restatement of Trust 3d"), reflects a "modern portfolio theory" and "total return" approach to the exercise of fiduciary investment discretion. This approach allows fiduciaries to utilize modern portfolio theory to guide investment decisions and requires risk versus return analysis. Therefore, a fiduciary's performance is measured on the performance of the entire portfolio, rather than individual investments. As of May 2004, the Prudent Investor Act has been adopted in 41 States and the District of Columbia. Other states may have adopted parts of the Act, but not the entire Act. According to the National Conference of Commissioners on Uniform State Laws, the most common portion of the Act excluded by states concerns the delegation of investment decisions to qualified and supervised agents.

The Prudent Investor Act differs from the Prudent Man Rule in four major ways:

- A trust account's entire investment portfolio is considered when determining the prudence of an individual investment. Under the Prudent Investor Act standard, a fiduciary would not be held liable for individual investment losses, so long as the investment, at the time of acquisition, is consistent with the overall portfolio objectives of the account.
- Diversification is explicitly required as a duty for prudent fiduciary investing.
- No category or type of investment is deemed inherently imprudent. Instead, suitability to the trust account's purposes and beneficiaries' needs is considered the determinant. As a result, junior lien loans, investments in limited partnerships, derivatives, futures, and similar investment vehicles, are not per se considered imprudent. However, while the fiduciary is now permitted, even encouraged, to develop greater flexibility in overall portfolio management, speculation and outright risk taking is not sanctioned by the rule either, and they remain subject to criticism and possible liability.
- A fiduciary is permitted to delegate investment management and other functions to third parties.

A copy of the model Uniform Prudent Investor Act, together with explanatory notes, is included in Appendix C. A list of states adopting the Uniform Prudent Investor Act is also included. States, however, may and often do, modify uniform model laws when enacting legislation. For states that have adopted a version of the Prudent Investor Rule, this portfolio management approach supersedes the Prudent Man Rule.

The Prudent Man Rule is based on common law, stemming from the 1830 Massachusetts court decision -- *Harvard College v. Armory*, 9 Pick. (26 Mass.)446, 461 (1830). The Prudent Man Rule directs trustees "to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested." Id. A copy of the Prudent Man Rule, also known as the Restatement of Trusts 2d, together with explanatory notes, is included in Appendix C.

Under the Prudent Man Rule, when the governing trust instrument or state law is silent concerning the types of investments permitted, the fiduciary is required to invest trust assets as a "prudent man" would invest his own property, keeping in mind: the needs of the beneficiaries, the need to preserve the estate (or corpus of the trust) and the amount and regularity of income. The application of these general principles depends on the type of account administered. This continues to be the prevailing statute in a small number of states.

The Prudent Man Rule requires that each investment be judged on its own merits. Thus, a fiduciary could be held liable for a loss in one investment, which when viewed in isolation may have been imprudent at the time it was acquired, but as a part of a total investment strategy, was a prudent investment in the context of the investment portfolio taken as a whole. Under the Prudent Man Rule, speculative or risky investments must be avoided. Certain types of investments, such as second mortgages or new business ventures, are viewed as intrinsically speculative, and, therefore, prohibited as fiduciary investments.

Since the Prudent Man Rule was last revised in 1959, numerous investment products have been introduced or have come into the mainstream. For example, in 1959, there were 155 mutual funds with nearly $16 billion in assets. By year-end 2000, mutual funds had grown to 10,725, with $6.9 trillion in assets (as reported by CDA/Wiesenberger). In addition, investors have become more sophisticated is more attuned to investments, since the last revision. As these two concepts converged, the Prudent Man Rule became less relevant.

Prudent Investments in Court-appointed Accounts

State statutes may outline specific permissible investments for certain types of accounts, such as guardianships for minor children or incompetents. Under some state statutes, prudence is more narrowly defined for guardianship accounts, than under the Prudent Man Rule.

Trust departments can be appointed as a conservator for veterans. In general, prudent investments for veteran accounts are defined as an interest or dividend paying account at a Federally-insured institution, or in court-appointed cases, in securities issued or guaranteed by the United States. Under 38 CFR13.103, veteran benefits paid to legal custodians on behalf of a beneficiary may only be invested in U.S. savings bonds, pre-need burials trusts, or interest or dividend paying accounts, which are Federally insured. Department of Veterans Affairs benefits that are paid on behalf of an incompetent veteran to an institution via an institutional award payment arrangement may not be invested in any asset. Pursuant to 38 USC 501, Section 13.106 states that court-appointed fiduciaries must invest income or an estate derived from the Department of Veterans Affairs benefits only in legal investments which have safety, assured income, stability of principal, and ready convertibility for the requirements of the beneficiary and his or her dependents.

Prudent Investments in Employee Benefit Accounts

Employee benefit accounts subject to ERISA are governed by the prudence requirement of ERISA Section 404(a)(1)(B), as well as by DOL Regulation 2550.404a-1. Also see recap of ERISA prudence interpretations and opinions. In implementing ERISA requirements, the Labor Department has generally followed the Prudent Investor approach outlined above.

D. Principal and Income

As discussed more fully in Section 2 - Operations and Internal Controls, there may exist different classes of beneficiaries in a personal trust account that may only be entitled to a trust's principal, or income, but not both. In these situations, it is important that fiduciaries maintain accounting records that clearly distinguish assets as either principal or income.

Principal (corpus) consists of cash and other property transferred to the fiduciary. Income is the return derived from the investment of principal. Income must also be distinguished from capital gains, which are not investment yields or returns on principal, but gains or appreciation of the value of the principal itself. Capital gains are added to the value of principal (capital losses reduce the value of principal), and inure to the benefit of principal beneficiaries. Depending on the terms of the trust, and a variety of other factors including the needs of the beneficiaries, income may be distributed as cash, or reinvested and held (for the benefit of income beneficiaries) as invested income. Unless clearly distinguished from other investments, invested income may appear to the observer to be principal. Consequently, it is imperative that fiduciary records distinguish between the two, as failure to do so could result in giving one set of beneficiaries funds that belong to another set of beneficiaries, creating a Contingent Liability. Separate records of principal and income are customary, and can be used for the preparation of accountings and tax returns. A further discussion of principal and income may be found in Principal and Income, located in Section 2.

E. Trust Investment Policies

The ultimate responsibility for establishing an overall investment policy remains with the board of directors or a trust committee appointed by the board. The basis of any investment policy should be sound fiduciary principles, including "prudence", the preservation of capital, diversification, and a rate of return commensurate with the level of risk assumed. The review of the department's investment policies and practices are of major importance in the trust examination.

Many trust departments have a separate trust investment committee which develops and administers investment policy, although smaller departments may utilize the board of directors or the trust committee for this purpose. The committee reviews and either approves or rejects recommendations made by a research division, an outside investment advisor, or the department's investment officer. Often the committee has the responsibility of reviewing individual account portfolios and determining whether assets are invested in compliance with the trust department's overall investment policy.

Accounts for which the department exercises investment discretion should receive an investment review in accordance with the Statement of Principles of Trust Department Management. An initial asset review should, in most cases, be conducted promptly following acceptance, and should establish an investment program for the account. Reviews should include securities and other types of assets received with the account. The initial review is of great importance, as the fiduciary may be required to act quickly to protect assets from loss or erosion of principal, or to take immediate action to protect tangible assets from creditors, insurable losses or physical damage. A fiduciary may have to compensate accounts that sustain investment losses due to the fiduciary's negligence such as a failure on the part of the fiduciary to act in a timely manner.

The department's overall investment policy should be flexible enough to accommodate the types of fiduciary appointments accepted. For example, individual trusts under will or agreement are usually established for the purpose of providing income to the income beneficiary and leaving principal (corpus) to the remainderman at the termination of the trust. By contrast, employee benefit trusts need to generate sufficient growth and income to provide the promised retirement benefits to participants and their beneficiaries. Conversely, investment management agency accounts normally desire capital growth rather than income.

When the governing instrument is silent, investment authority or directions default to state law, which must be followed. When the governing instrument's language concerning investments is unclear, court approval should be obtained.

E.1. Investment Policy Components

Investment policies should clearly set forth a framework for the selection, retention, review, and management of assets over which the department holds investment discretion. The policies should discuss the overall structure of the department's investment management responsibilities. They should provide for: appointing qualified officers to supervise daily investment activities; the monitoring of discretionary transactions, including the reporting of such transactions to the appropriate supervisory officers and committees; procedures for handling exceptions; and, formal procedures for reviewing and revising investment policies and practices. Depending on a department's size, complexity, and the types of appointments accepted, the following elements may also need to be addressed:

- Management's investment philosophy and standards of practice.
- A code of conduct for employees, officers, and directors who by their duties or supervisory roles have knowledge of, or access to: (1) discretionary investment transactions; or (2) the department's approved list of securities, or changes to the approved list of securities. FDIC Part 344 requires that bank officers and employees who make investment recommendations or decisions for accounts of customers file a report with the bank on a quarterly basis.
- Investments and investment practices deemed appropriate, or inappropriate, with regard to the management of discretionary accounts.
- The nature and size of accounts the department is qualified to administer, and the minimum standards required for the acceptance of new accounts.
- Pre-acceptance review of the transferred assets for new accounts.
- The initial review of newly accepted accounts.
- Investment reviews of existing accounts.
- Procedures for documenting investment reviews.
- Whether the department will prepare its own research in-house, or purchase investment research from outside investment advisors.
- Guidelines governing the use of outside investment advisor refer to Section 10.G.6) including:
    - Procedures for adopting and/or amending an approved list of investments recommended by outside advisors, if appropriate,
    - Procedures for diverging from outside advisor recommendations when appropriate, and
    - Procedures for monitoring purchases and sales to ensure compliance with the approved lists.
- Procedures for adopting and amending an approved list of equity investments based on in-house research, including:

    - Criteria for selecting the investments to be included on approved lists,
    - Criteria for monitoring the investments included on approved lists,
    - Description of the approval process for adding or deleting investments from approved lists, including specifying the person(s) having authority to make such additions or deletions, and
    - Monitoring purchases and sales to ensure compliance with the approved lists.
    - Procedures for making exceptions to the approved lists.
- Procedures for adopting and amending an approved list of mutual fund investments (inclusive of proprietary mutual funds, refer to subsection F.4.a, if appropriate) including:
    - Justification for the selection of a load fund over a no-load fund.
    - Criteria for the selection of the mutual funds to be included on approved lists,
    - Criteria for monitoring the mutual funds on the approved lists, and
    - Description of the approval process for adding or deleting mutual funds from the approved lists.
    - Criteria for diverging from the approved lists.
- Establishment of procedures for adopting and amending an approved list of obligors (corporate and municipal) of fixed income debt investments, if applicable, including:
    - Criteria for evaluating the credit risk of the obligors to be included on the approved lists,
    - Criteria for monitoring the credit risk of the obligors on the approved lists,
    - Description of the approval process for adding or deleting obligors from the approved lists, and
    - Monitoring purchases and sales to ensure compliance with the approved lists.
    - Criteria for making exceptions to the approved list.
- Guidelines for the development and use of asset allocation models, including:
    - Criteria or methodology for creating and modifying asset allocation models, and
    - Description of the process for supervisory review and approval of the models.
- Guidelines for the holding, purchasing, and managing of real property, including:

    - The evaluation of environmental risk, initially, and on an ongoing basis, and
    - Initial and periodic reappraisals/inspections of real property.
- Guidelines and procedures for holding closely held businesses, including:
    - Identification of conditions under which the department would administer such assets.
    - Criteria for contracting with a third party to run a closely-held business.
    - Methods and procedures for the initial and periodic evaluation of such assets
    - Whether the trust officer should serve on the board.
- Guidelines and procedures employed in the selection and use of money market mutual funds, including:
    - Periodic reviews of fund performance,
    - Methods for monitoring the use of and reliance on derivative products by such funds, and
    - Guidelines for the selection and use of funds paying 12b-1 fees, including: the appropriateness of such funds for each type of account administered, notification to customers of such fees, the solicitation of customer approvals when appropriate, and the routine disclosure to customers of such fees earned by investment of their accounts in such funds.
- Guidelines governing the use and monitoring of derivative investment products, as outlined in the FDIC Office of Capital Markets Examination Handbook and the FDIC Statement of Policy on Investment Securities and End-User Derivative Activities.
- Guidelines for the evaluation and management of assets deemed worthless.
- Guidelines and procedures for evaluating and monitoring exceptions, such as non-rated, or non-approved list, securities held in accounts. Refer to the following section.
- Guidelines and practices for securities lending. Refer to F.15.
- Guidelines and procedures governing loans from trust accounts (real estate, unsecured promissory notes, etc.).
- Guidelines and procedures regarding lending to, and permitted indebtedness of, managed accounts.

Guidelines providing for the prompt investment of income and principal cash, unless the governing instrument, local law, or parties properly authorized to direct investments provide otherwise.