What OCC Regulation of Corporate Fiduciaries Means to the Practicing Attorney

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Introduction

Based on an unscientific survey of trusts and estates attorneys, the OCC intrudes into the consciousness of those practitioners rarely, if at all. The most common response when I ask the question is, "The what?"

> The Officer of the Comptroller of the Currency charters, regulates, and supervises all national banks. The OCC was established in 1863 as a bureau of the U.S. Department of the Treasury. The OCC is headed by the Comptroller, who is appointed by the President, with the advice and consent of the Senate, for a five-year term. The Comptroller also serves as a director of the Federal Deposit Insurance Corporation (FDIC) and a director of the Neighborhood Reinvestment Corporation.
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> The OCC's nationwide staff of examiners conducts on-site reviews of national banks and provides sustained supervision of bank operations. The agency issues rules, legal interpretations, and corporate decisions concerning banking, bank investments, bank community development activities, and other aspects of bank operations. www.occ.gov

In contrast to the drafting attorneys, trust officers are aware of OCC regulation on a daily basis. It affects just about every area of trust administration. We can't forget about it, because most banks will have an on-site examination from the OCC every year. Some exams are more detailed than others, but trust officers always know that a bank regulator is looking over their shoulders.

The OCC uses the Uniform Financial Institutions Rating System (UFIRS) to evaluate a national bank's fiduciary operations. Each bank gets a composite rating based on five factors: management, adequacy of operations and controls and audits, quality of earnings, compliance with laws and regulations and governing instruments, and asset management. The ratings go from a high of 1 to a low of 5. A rating of 1 indicates strong performance by the bank and the least degree of supervisory concern. A rating of 2 indicates that the bank is fundamentally sound. A 3 rating indicates general adequacy. A rating of 4 indicates the presence of at least one major problem and 5 indicates very weak performance and a high degree of supervisory concern. Regulatory Compliance Associates, Inc., *Sheshunoff Trust Department Policies and Procedures Manual* 9-3 (2001) [hereinafter *Sheshunoff*].

If the OCC assigns a rating of 3, 4 or 5, additional supervision will be imposed. Additional reports will be required, examinations will be more frequent. The OCC may issue a cease and desist order for a 4 or 5 rated bank, preventing it from opening any new fiduciary accounts until deficiencies are remedied. The OCC can also revoke a bank's trust powers.

Even though OCC regulation is not on most practitioners' radar screens, it can intrude on the lives of their clients and the clients' beneficiaries. These are most common situations where this occurs:

I. Pre-acceptance review of assets
II. Annual review of account
III. Discretionary distributions
IV. Concentrated investment positions
V. Successor trustee appointments

What all of these topics share is the need for client expectations to be managed at the beginning of a relationship with a corporate trustee. My hope is that if drafting attorneys are aware of the regulatory constraints under which bank trustees operate, then our mutual clients will be more satisfied with the management of their affairs. Carried to the next generation, your clients' beneficiaries will also have a better understanding of how trusts for their benefit operate and their role in making their relationship with their trustee more productive.

<u>I. Pre-acceptance review of assets 12 CFR 9.6</u>

What the rule says:

> Review of fiduciary accounts.
> (a) *Pre-acceptance review*. Before accepting a fiduciary account, a national bank shall review the prospective account to determine whether it can properly administer the account.
> (b) *Initial post-acceptance review*. Upon the acceptance of a fiduciary account for which a national bank has investment discretion, the bank shall conduct a prompt review of all assets of the account to evaluate whether they are appropriate for the account. 12 CFR 9.6

What it means to the OCC examiners:

> The bank should establish a due diligence process for reviewing each prospective account. The due diligence process should consider applicable risk management issues and ensure compliance with the bank's policies and procedures. The results of an account's due diligence review should be documented and recorded in the appropriate bank record file.
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> The assets used to fund the account should be reviewed as part of the pre-acceptance review. The committee should not accept an account that holds assets that are beyond the skill and expertise of the bank's staff to properly administer. The bank would be expected to acquire the appropriate expertise before accepting the account or to decline the appointment. Assets that are more likely to be illiquid, such as real estate, family businesses, oil and gas properties, foreign assets, and art, should be carefully reviewed. Comptroller of the Currency, *Comptroller's Handbook, Personal Fiduciary Services* 27 (2002) [hereinafter *Comptroller's*

Handbook].

What it means on the ground:

Prior to opening a fiduciary account, the business development officer and/or the trust officer will meet with the prospective clients, usually more than once, to go over their needs and expectations. Review of assets is straightforward for marketable securities, but gets much more in depth for what we call "special assets:" real estate, mineral interests, oil and gas interests, and closely held interests.

If a bank accepts an account containing special assets without conducting a detailed review, the bank will hear about it at the next OCC exam. Real estate is the most common special asset, and also the riskiest. Although it is not written down in the Comptroller's Handbook, industry practice requires an inspection of all real estate prior to acceptance by someone with expertise in the area. The primary goal of the inspection is to prevent acceptance of property with environmental contamination. A sample inspection form is attached.

What this means for the drafter:

There's nothing worse for a trust officer than getting off on the wrong foot with new clients. Problems will be avoided if they understand that there is an extra step in establishing their trust account where real estate is involved.

> Example: Mr. Andersson inherited Minnesota farmland from his father several years ago. It has appreciated significantly. Mr. Andersson lives in Colorado and has decided that long-distance farm management is not how he wants to spend his golden years. He decides, after consulting with his estate planning attorney, to give the property to a CRT. But there's a wrinkle. The only real market for farmland in this area of Minnesota is an auction that takes place in November each year. Mr. Andersson wants to put the property up for auction; if he gets a good bid, he plans to transfer the land to the CRT and have it sold from there. If he doesn't get a bid he likes, he plans to put the CRT document in his desk drawer until next November and try again then.
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> Mr. Andersson's lawyer contacts bank two days before the auction and asks the bank to accept as trustee. Mr. Andersson is surprised to learn that the bank will have to get a qualified person to set foot on the property before it can accept as trustee. Mr. Andersson is annoyed at his attorney for not telling him about the delay and at the bank for being "persnickety".

II. Annual review of account

What the rule says:

> (c) *Annual review*. At least once during every calendar year, a bank shall conduct a review of all assets of each fiduciary account for which the bank has investment discretion to evaluate whether they are appropriate, individually and collectively, for the account. 12 CFR 9.6(c)

What it means to the OCC examiners:

> The review should consider the account's investment policy statement, analyze investment performance, and reaffirm or change the investment policy statement, including asset allocation guidelines. If certain assets are no longer appropriate for the account, those assets should be replaced consistent with prudent investment practices. Items to consider include account objectives, the needs of the beneficiaries, and income tax consequences.
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> Fiduciaries *may* also perform periodic *administrative* account reviews to determine whether the account is being administered in accordance with the terms and conditions of the governing instrument. Periodic account reviews are generally completed by an administrative officer working with a designated investment manager or advisor, and are normally submitted to and reviewed by an appropriate fiduciary committee. *Comptroller's Handbook* 32 (emphasis added).

What it means on the ground:

There's no "may" about it. Any bank that doesn't do an annual administrative review on each account will get a black mark. "12 CFR 9 does not specifically require administrative account reviews. However, administrative reviews are considered essential from a risk management perspective. Since the underlying principle behind bank regulation is effective management of risks, examiner can cite a bank for failing to perform administrative reviews under certain circumstances or take this fact into consideration in determining bank ratings." *Sheshunoff* 8-11.

For each account, the trust officer needs to have sufficient contacts with and information about the beneficial owners of the account to make an informed judgment about the appropriateness of the investments and whether the account is serving its purpose. Banks have some freedom in determining the format of these reviews, but they are some of the first things OCC examiners look for in each file.

What this means for the drafter:

We're not being nosy – we need to ask beneficiaries about their lives in order to be able to document whether or not the bank is doing its job. Drafting attorneys could help families know what to expect when they are considering who will be making decisions down the road. When parents are