

Do You Really Want To Do THAT?!?

Wednesday, May 3, 2023

FIRMA 36th Annual Conference

San Antonio, TX



Blocking and Tackling



Blocking and Tackling

- **It Takes a Team of Professionals**
 - *The team of professionals must all be on the same page with differing opinions and perspectives.*
 - *Culture of High Expectations*
- **Know the Numbers**
 - *Know how the Balance Sheet is tied to the P&L and Cash Flow Statement.*
 - *Drill Deep into the Details and Know What is Working*
- **Profit is a Must**
 - *Generating a Profit is Your Responsibility to Keep Your Property Sustainable.*
 - *Profits Allow for Reinvestment and Relevance*
- **Deliver**
 - *You must do what you said you were going to do.*
 - *Talk the Talk AND Walk the Walk*

Applicable Law

Applicable law means the terms of the instrument governing a fiduciary relationship, any court order pertaining to the relationship, the law of a state or other jurisdiction governing the fiduciary relationship, or any applicable Federal law governing those relationships.

Numerous Governing Instruments

50 State Laws

Uniform Laws (????)

Federal Laws and Regulations

12 CFR 9 - OCC

ERISA – DOL

Tax Law – IRS

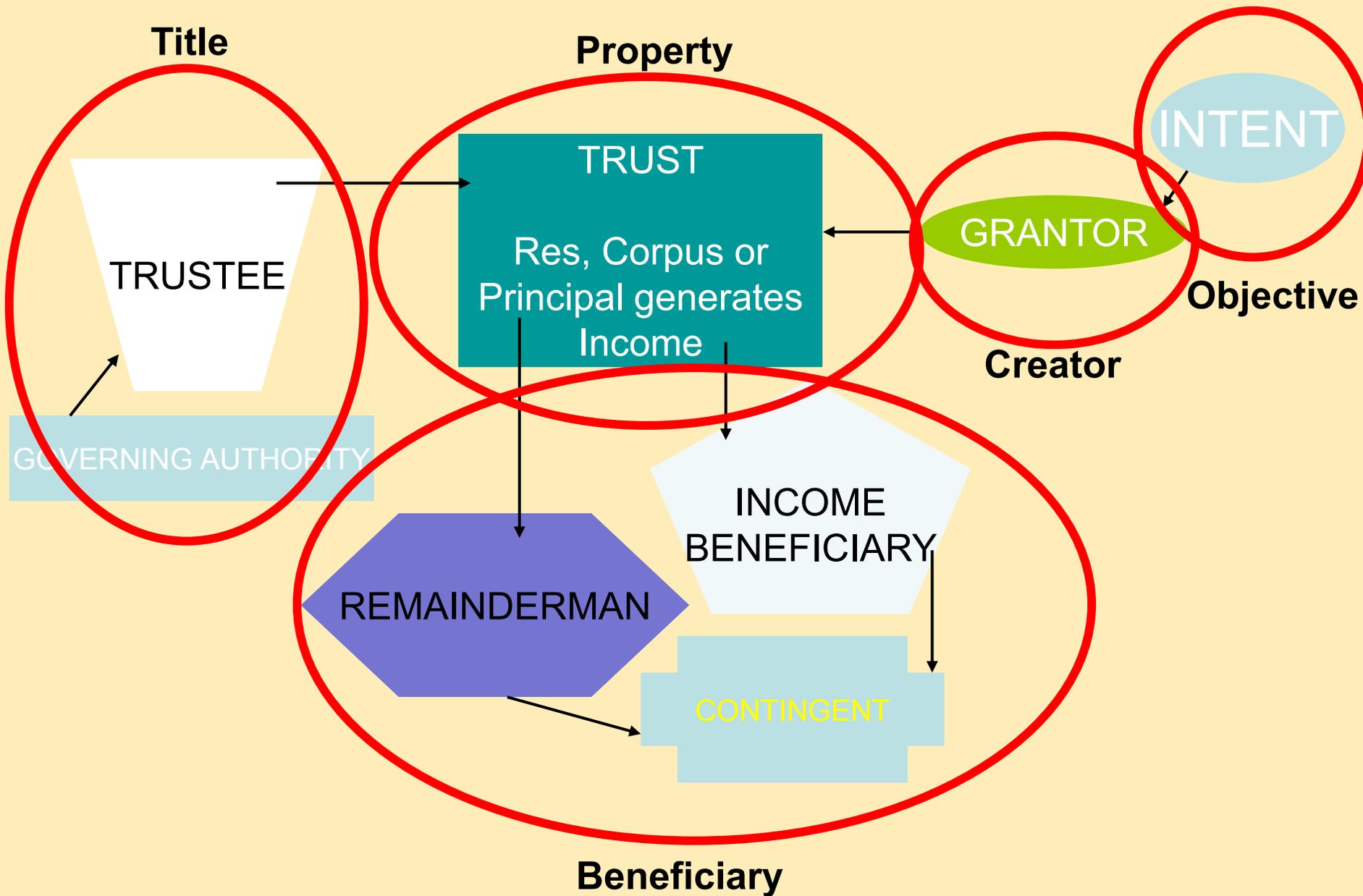
Securities Law – SEC

And on, and on, and on

Uniform Prudent Investor Act

- The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting the term “portfolio” embraces all the trust’s assets.
- The tradeoff in all investing between risk and return is identified as the fiduciary’s central consideration.
- All categoric restrictions on types of investments have been abrogated; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing.
- The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing.
- The much criticized former rule of trust law forbidding the trustee to delegate investment and management functions has been reversed. Delegation is now permitted, subject to safeguards.

Required Elements of a Trust



Why Does This Matter?

- **Company Articles of Incorporation and By Laws**
- **Board of Directors and Executive Management**
- **Shareholders**
- **Regulators – Federal and State**
- **Employees**
- **Financial Markets**

Why Does This Matter?

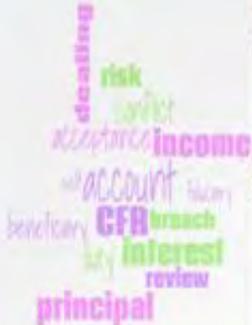


Mom, that's why?

Sue your trustee...
Call ME!!!



\$\$



I Sue
Trust
Companies

Management

The capability of the board of directors and management, to identify, measure, monitor and control the risks of an institution's fiduciary activities.

- **Level and quality of oversight** and support of fiduciary activities by the board of directors and management
- Ability of the board of directors and management to plan for, and respond to, risks that may arise from changing business conditions
- Adequacy of, and conformance with, appropriate internal policies, procedures, and controls
- **Strategic planning** for fiduciary products and services
- The overall level of compliance with laws, regulations, and sound fiduciary principles
- The availability of **competent legal counsel**

Management

Competent Legal Counsel:

The Internal Revenue Code (law) does not permit IRA funds to be invested in life insurance or collectibles. If you invest your IRA in collectibles, the amount invested is considered distributed in the year invested and you may have to pay a 10% additional tax on early distributions. Here are some examples of collectibles:

- Artwork,
- Rugs,
- Antiques,
- Metals - with exceptions for certain kinds of bullion,
- Gems,
- Stamps,
- Coins - (but there are exceptions for certain coins),
- Alcoholic beverages, and
- **Certain other tangible personal property.**

Management – You Really Want To Do That?

Competent Legal Counsel:



Management

Strategic Planning:

- Establish a plan that moves towards the company's mission statement and its long term goals.
- Provides a process towards achieving and tracking company goals.
- Sets the direction of the company from its leadership without straining resources or creating undue or unnecessary risk.
- Understands “good” revenue and “undesirable” revenue – sales culture.
- Communicated to all departments, divisions, employees, and shareholders.
- Provides for accountability.

Management – You Really Want To Do That?

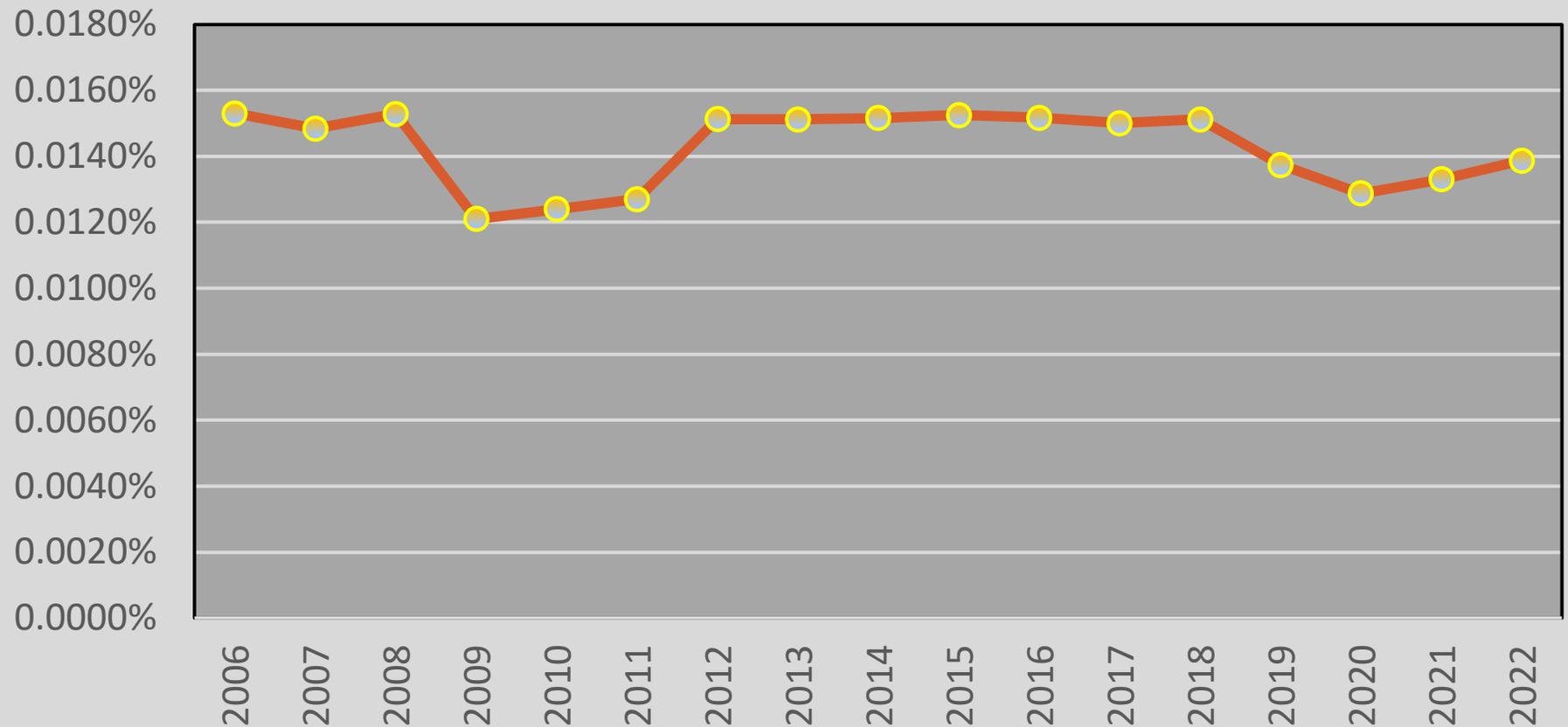
Strategic Planning:



Management – You Really Want To Do That?

Strategic Planning:

Industry Analysis: Return on Custody Assets - Under Administration



Management

Level and Quality of Oversight:

- Management reports and discussion specific to the fiduciary business.
- Performance analysis outlining compliance with stated objectives and strategic plan.
- Knowledge of the business within the institution and that of the industry.
- Ability to ask quality questions and receive appropriate answers.

Management – You Really Want To Do That?

Level and Quality of Oversight:

Client Bank	12/31/2016	12/31/2017	12/31/2018	12/31/2019	12/31/2020	12/31/2021
PERSONAL TRUST						
- Average Account Size	\$5,208,478	\$2,832,614	\$2,889,383	\$2,658,508	\$3,492,347	\$3,988,284
- Average Revenue/Account	\$7,539	\$6,866	\$7,398	\$5,868	\$7,665	\$9,006
- ROFA (Return On Fiduciary Assets)	14.48	24.24	25.61	22.07	21.95	22.58
- \$ Amount of Discretionary Assets	\$1,212,933,000	\$2,004,964,000	\$1,909,995,000	\$2,296,857,000	\$2,492,364,000	\$2,883,231,000
- \$ Amount of Non Discretionary Assets	\$651,702,000	\$714,345,000	\$788,689,000	\$989,059,000	\$951,090,000	\$1,308,456,000
- # of Discretionary Accounts	297	893	864	1135	876	897
- # of Non Discretionary Accounts	61	67	70	101	110	154
IRA ACCOUNTS						
- Average Account Size	\$346,413	\$375,158	\$351,562	\$298,878	\$435,539	\$457,306
- Average Revenue/Account	\$0	\$2,936	\$3,064	\$2,341	\$3,264	\$3,785
- ROFA (Return On Fiduciary Assets)	0.00	78.25	87.15	78.31	74.94	82.78
- \$ Amount of Discretionary Assets	\$315,929,000	\$351,836,000	\$315,902,000	\$346,489,000	\$372,124,000	\$378,186,000
- \$ Amount of Non Discretionary Assets	\$0	\$20,696,000	\$19,488,000	\$22,028,000	\$22,474,000	\$22,414,000
- # of Discretionary Accounts	912	938	901	1167	862	837
- # of Non Discretionary Accounts	0	55	53	66	44	39
FOUNDATIONS & ENDOWMENTS						
- Average Account Size	\$1,909,250	\$2,067,723	\$1,972,409	\$1,544,545	\$3,381,439	\$3,889,558
- Average Revenue/Account	\$0	\$9,894	\$10,455	\$7,564	\$11,976	\$16,698
- ROFA (Return On Fiduciary Assets)	0.00	47.85	53.00	48.97	35.42	42.93
- \$ Amount of Discretionary Assets	\$84,007,000	\$97,183,000	\$86,786,000	\$84,950,000	\$138,639,000	\$167,251,000
- \$ Amount of Non Discretionary Assets	\$0	\$0	\$0	\$0	\$0	\$0
- # of Discretionary Accounts	44	47	44	55	41	43
- # of Non Discretionary Accounts	0	0	0	0	0	0
INVESTMENT MANAGEMENT ACCOUNTS						
- Average Account Size	\$865,419	\$934,194	\$802,370	\$726,911	\$1,238,035	\$1,382,902
- Average Revenue/Account	\$8,549	\$5,067	\$5,074	\$3,589	\$5,744	\$7,998
- ROFA (Return On Fiduciary Assets)	98.78	54.24	63.23	49.38	46.39	57.83
- \$ Amount of Discretionary Assets	\$1,034,176,000	\$610,963,000	\$490,248,000	\$601,882,000	\$680,919,000	\$791,020,000
- \$ Amount of Non Discretionary Assets	\$0	\$0	\$0	\$0	\$0	\$0
- # of Discretionary Accounts	1,195	654	611	828	550	572
- # of Non Discretionary Accounts	0	0	0	0	0	0
OPPORTUNITY ANALYSIS INDICATORS						
- TOTAL ROFA for PT, IRA, F&E, and IMA	39.15	34.96	37.09	31.16	30.41	32.56
- Profit Margin (Net)	2.54%	11.83%	9.00%	20.99%	16.30%	26.16%
- Revenue and Expense Growth Metric (Net)	-12.63	10.00%	-2.38%	12.48%	-6.01%	14.76%

Management – You Really Want To Do That?

Level and Quality of Oversight:

Opportunity Analysis Indicators	2016	2017	2018	2019	2020	2021
TOTAL ROFA for PT, IRA F&E, and IMA						
Client Bank	39.15	34.96	37.09	31.16	30.41	32.56
Indsutry	84.24	85.78	85.67	83.19	84.16	81.34
Variance	-45.09	-50.82	-48.58	-52.03	-53.75	-48.78
Profit Margin (Net)						
Client Bank	2.54%	11.83%	9.00%	20.99%	16.30%	26.16%
Indsutry	23.48%	22.35%	21.68%	24.71%	25.38%	29.67%
Variance	-20.94%	-10.52%	-12.68%	-3.72%	-9.08%	-3.51%
Revenue and Expesne Growth Metric (Net)						
Client Bank	-12.63%	10.00%	-2.38%	12.48%	-6.01%	14.76%
Indsutry	0.65%	1.20%	-1.34%	-0.61%	3.71%	6.61%
Variance	-13.28%	8.80%	-1.04%	13.09%	-9.72%	8.15%

Service Quality

- **Risk Statement**: Account terminations/closures due to aging population, organic terminating events, poor administration, investment performance, resulting in lost business, reduced fee revenue and potential safety and soundness issues.

Duty to
Communicate

Risk Causes: Poor client retention practices include, lack of regular client contact, lack of anticipating termination and distribution events, lack of adequate complaint resolution procedures for administrative and investment issues (ie. performance).

Conflicts of Interest

- **Risk Statement**: Inadequate controls over the use of own bank products ie. mutual funds other affiliated products, like securities underwritings, derivatives etc. can lead to numerous conflicts of interests. In addition, employees (both direct and from affiliates) need to be aware of and understand those situations that can create a conflict of interest.

Duty of
Undivided
Loyalty

Risk Causes: The repeal of Glass Steagle 1999 and implementation of the Gramm, Leach Bliley Act ushered in a new era of investment banking by national banks, broker dealers and mutual funds that required heightened risk management practices. This placed an enormous burden on trust departments to be vigilant and install monitoring controls with respect to affiliated products like money market funds used as sweep vehicles for example.

Operations, Internal Controls, Audit

The adequacy of the institution's fiduciary operating systems and **internal controls** in relation to the volume and character of business conducted. Audit coverage must assure the integrity of the financial records, the **sufficiency of internal controls**, and the adequacy of the compliance process.

- Staff, Facilities, and Operating Systems
- Records, Accounting, and Data Processing
- **Vault Controls** and Security Movement
- **Segregation of Duties**
- Reconciliation Processes
- Independence, Frequency, Quality and Scope of Audit
- Identification, Tracking, and Resolution of Issues

Operations, Internal Controls, Audit

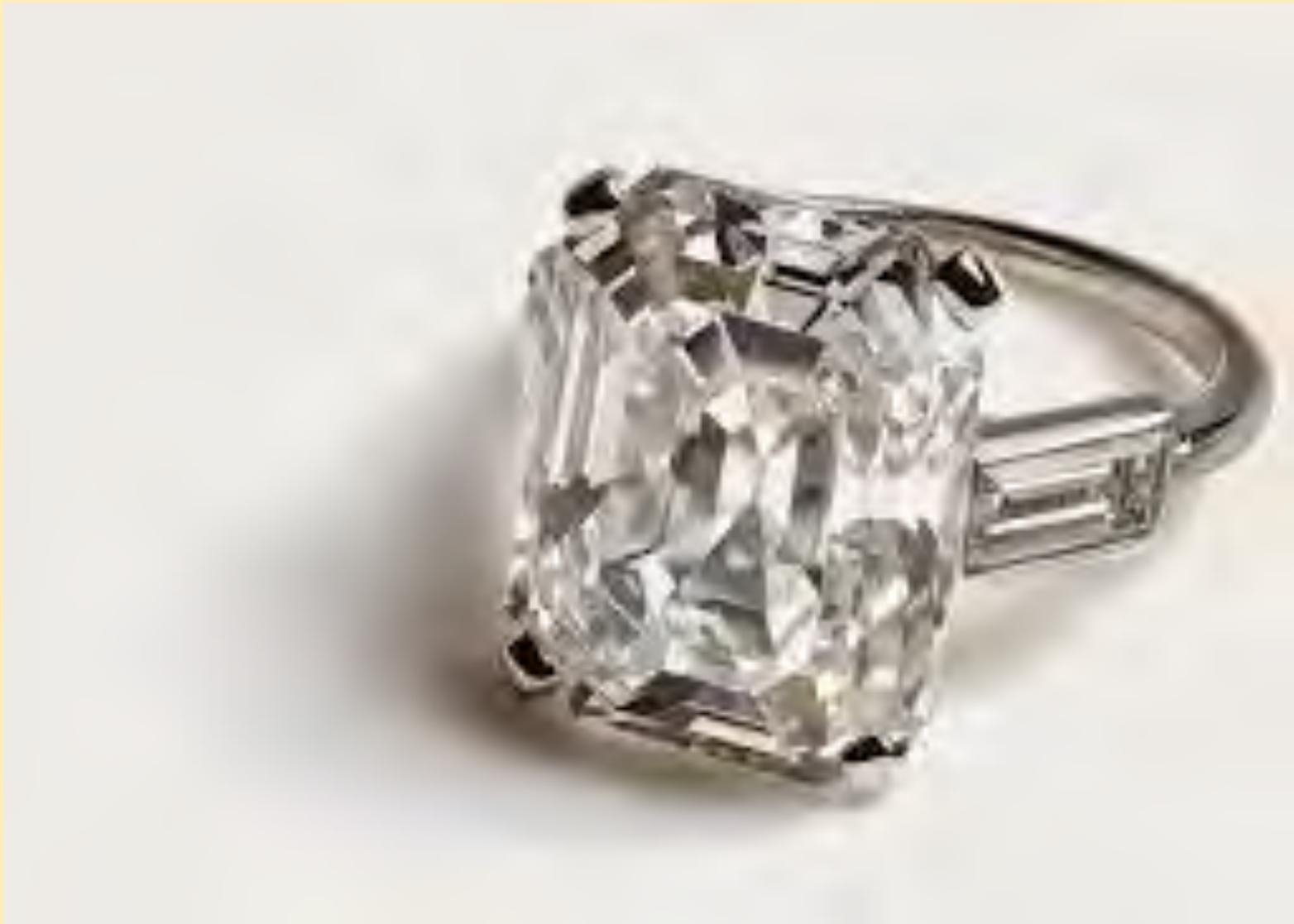
Internal Controls:

- Dual Control
 - Independent operations personnel perform annual physical inventories of assets.
 - Inspections should be reconciled to trust vault safekeeping reports at least annually, if not quarterly.
 - Strong dual control procedures should also limit access to fiduciary assets maintained in the vault, requiring two individuals are required to access the vault and transfer assets maintained in the vault.
 - A record of transfers should be maintained by trust operations personnel.

Operations, Internal Controls, Audit

- You Really Want To Do That?

Internal Controls: Dual Control



Operations, Internal Controls, Audit

Internal Controls:

- Segregation of Duties
 - Share responsibilities of key business process through the distribution people and departments
 - Prevent unilateral actions and decisions within a department or division.
 - Places business-critical tasks into four categories; authorization, custody, recordkeeping, and reconciliation – no one person or department holds responsibility in multiple categories.

Operations, Internal Controls, Audit

– You Really Want To Do That?

Internal Controls: Segregation of Duties



Earnings

The profitability of an institution's fiduciary activities and its **effect on the financial condition of the institution**. The use and adequacy of budgets and **earnings projections by** functions, product lines and **clients are reviewed and evaluated**. Risk exposure that may lead to negative earnings is also evaluated.

- **Level and Consistency of Profitability**
- **Dependence Upon non-Recurring Fees and Commissions**
- Effect of Charge Offs and Other Compromises
- **Unusual Features and the Composition of Business and Fee Schedules**
- **Use of Cost Analysis Procedures**
- Methods Used by Directors for Approval of Financial Projections and Budgets
- **New Business Development Efforts and Plans**

Earnings

Level and Consistency of Profitability:

- Awareness of revenue streams by product and client.
- Consistent application of a Board/Committee Approved fee schedule.
- Contribution to the Non-Interest Income Component of the Institution.
- Knowledge of risks within the Account Portfolio.
- Trend analysis and application of Key Risk Indicators (KRIs).

Earnings

Level and Consistency of Profitability:

- **12 CFR 9.15 (a)** - If the amount of bank's compensation for acting in a fiduciary capacity is not set or governed by applicable law, the bank may charge a **reasonable** fee for its services.
- **Article 7 Uniform Prudent Investor Act** - In investing and managing trust assets, a trustee may only incur costs that are appropriate and **reasonable** in relation to the assets, the purposes of the trust, and the skills of the trustee.

Reasonable = Fair

Earnings

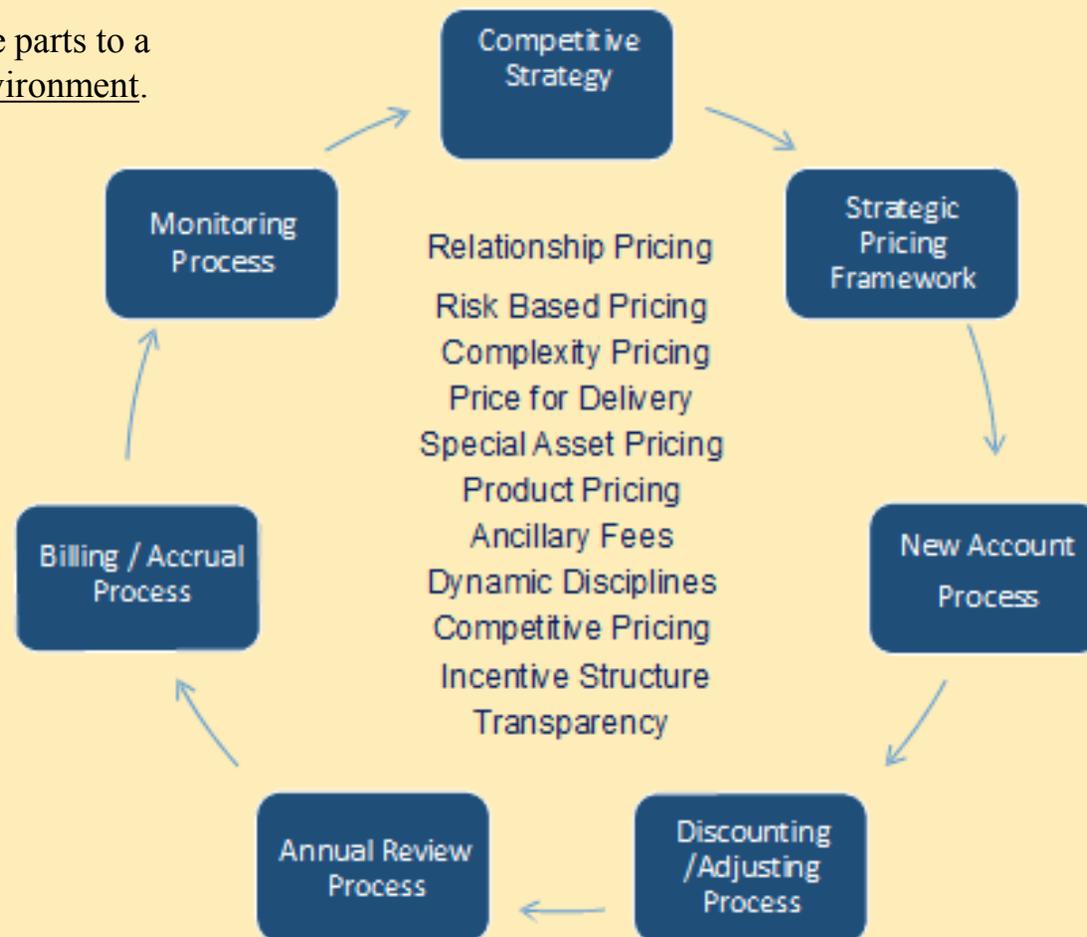
Level and Consistency of Profitability:



Price Realization - Optimization

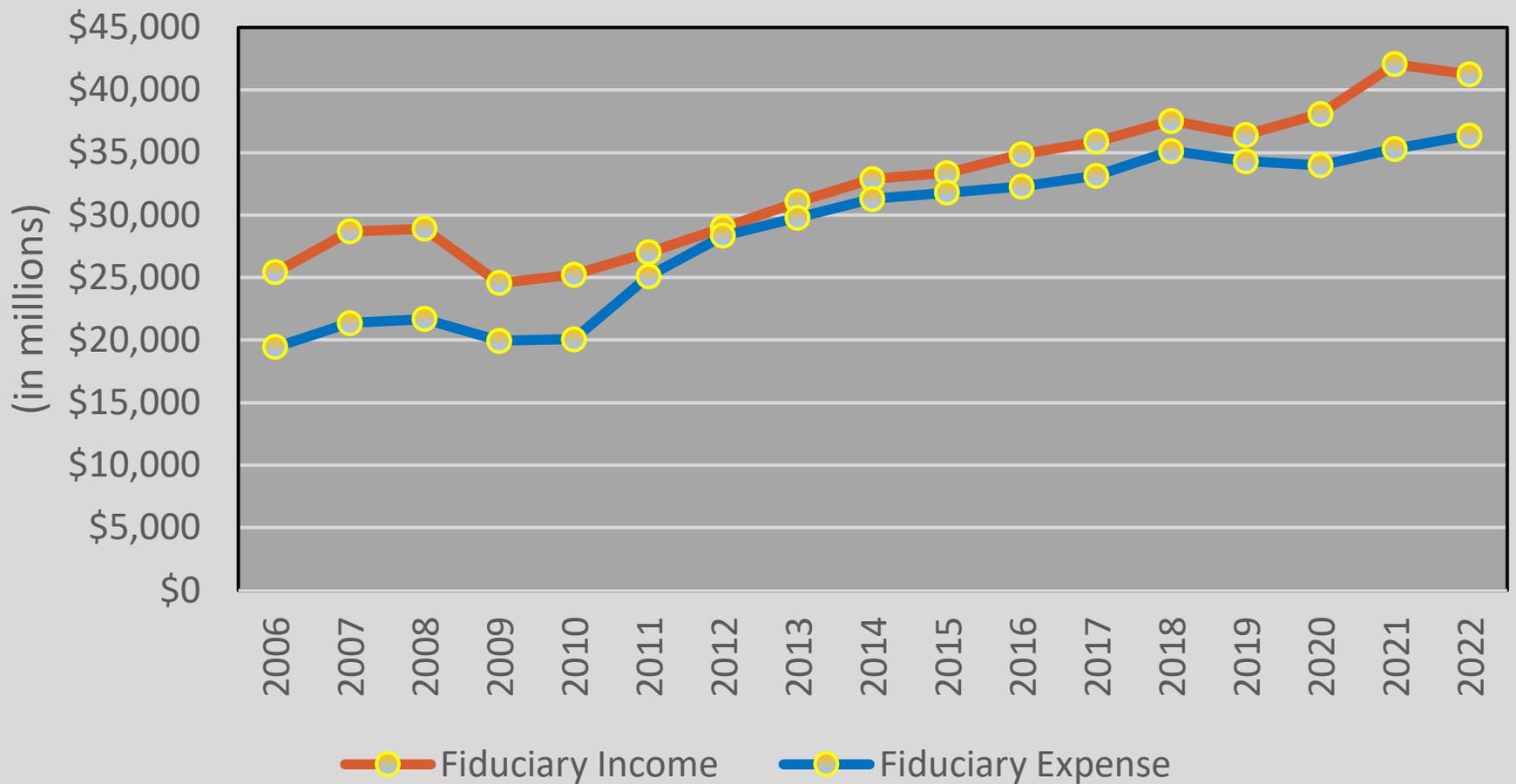
“Studies show that pricing is the most critical profit driver in business, but it is also one of the least understood. Many executives with pricing responsibilities rely on instinct or a simple cost plus model to set prices, ignoring the complexities inherent in price strategies — and they fail to capture maximum value”. Wharton Business School – Pricing Strategies

There are many unique parts to a disciplined pricing environment.



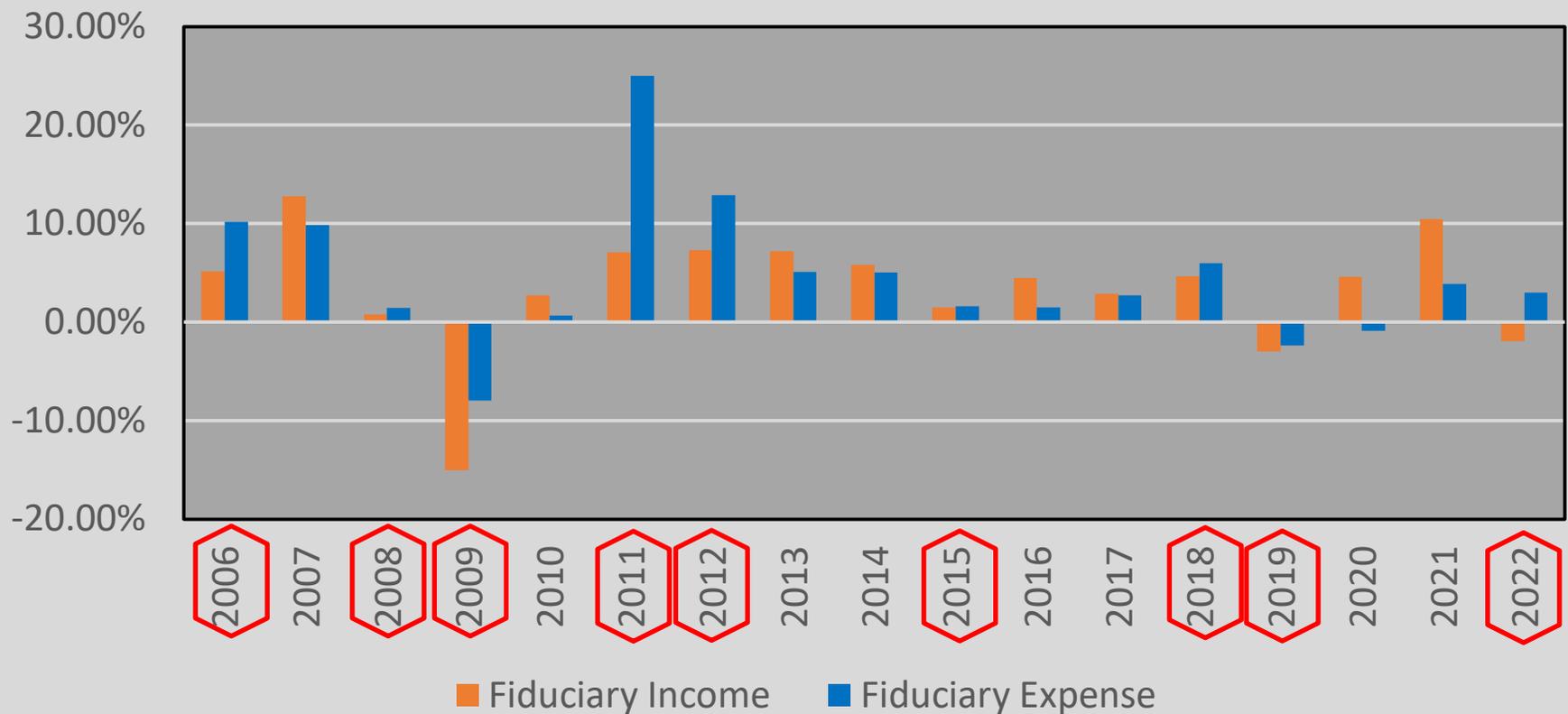
Earnings – You Really Want To Do That?

Industry Analysis: Fiduciary Income & Expense



Earnings – You Really Want To Do That?

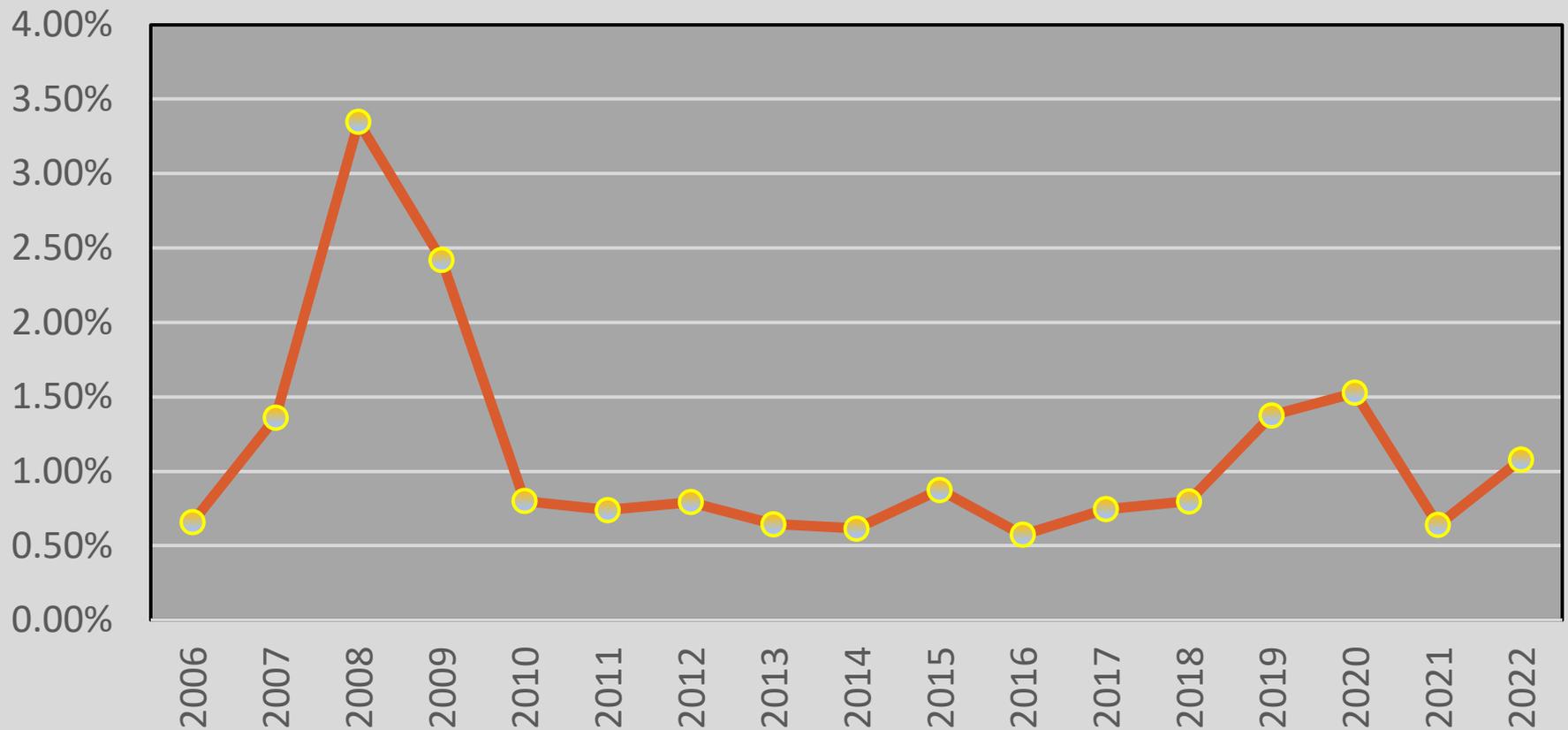
Industry Analysis: Income & Expense Growth Rates for Fiduciary Activities



 Represents years where Expense growth was greater than Revenue growth or Expense decrease was less than Revenue decrease

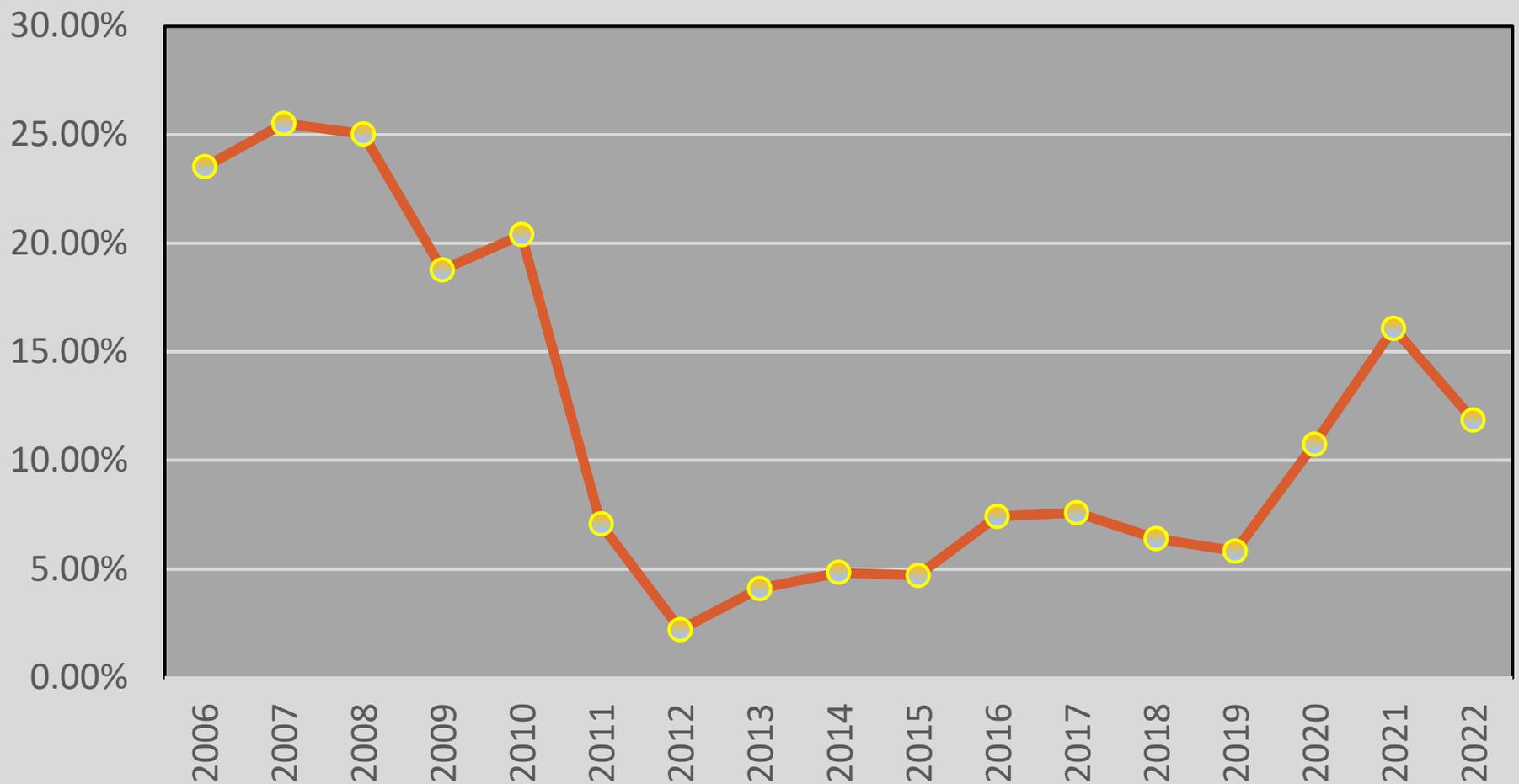
Earnings – You Really Want To Do That?

Industry Analysis: Net Losses as a % of Gross Fiduciary Income



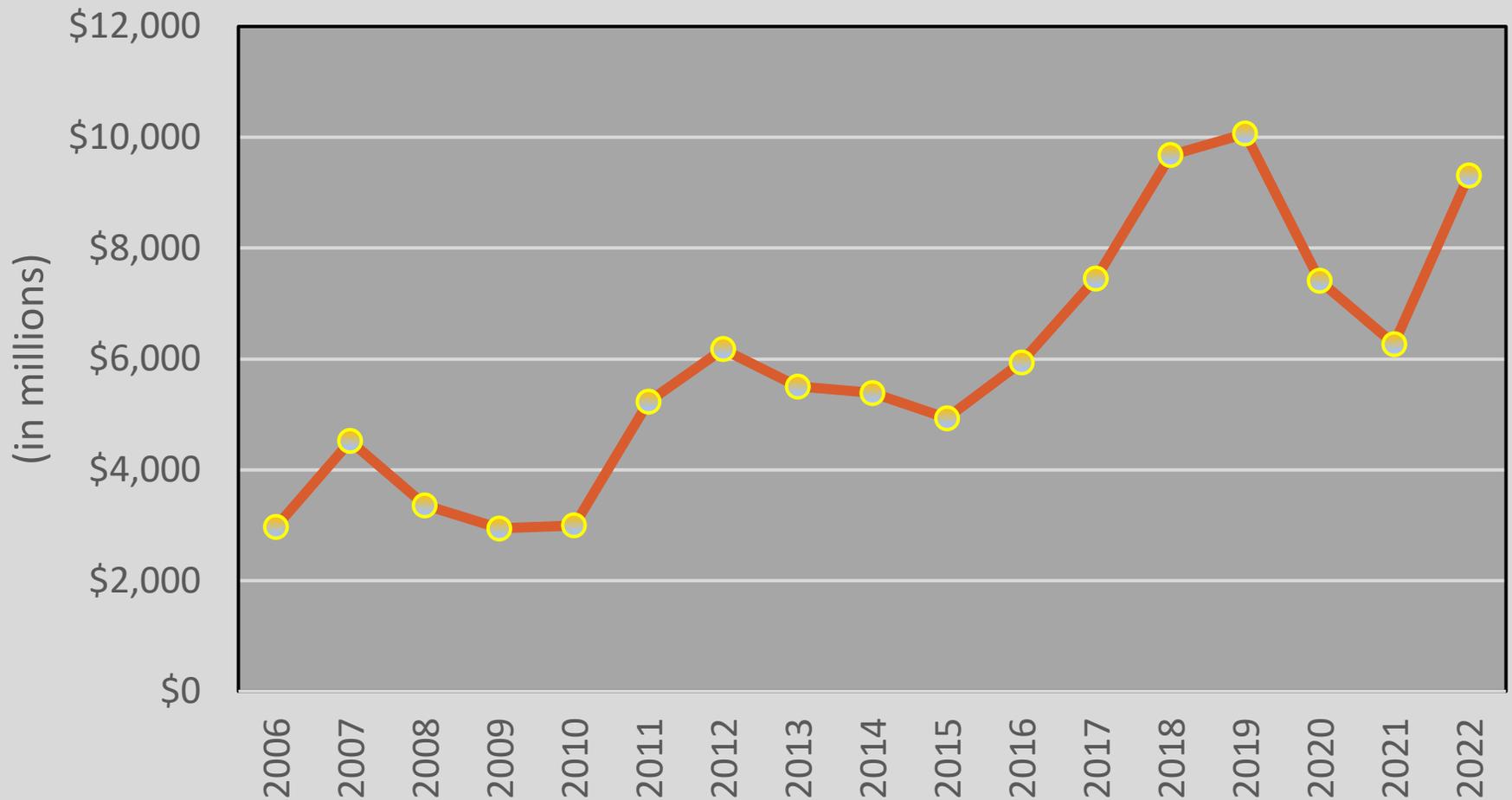
Earnings – You Really Want To Do That?

Industry Analysis: Profit Margin



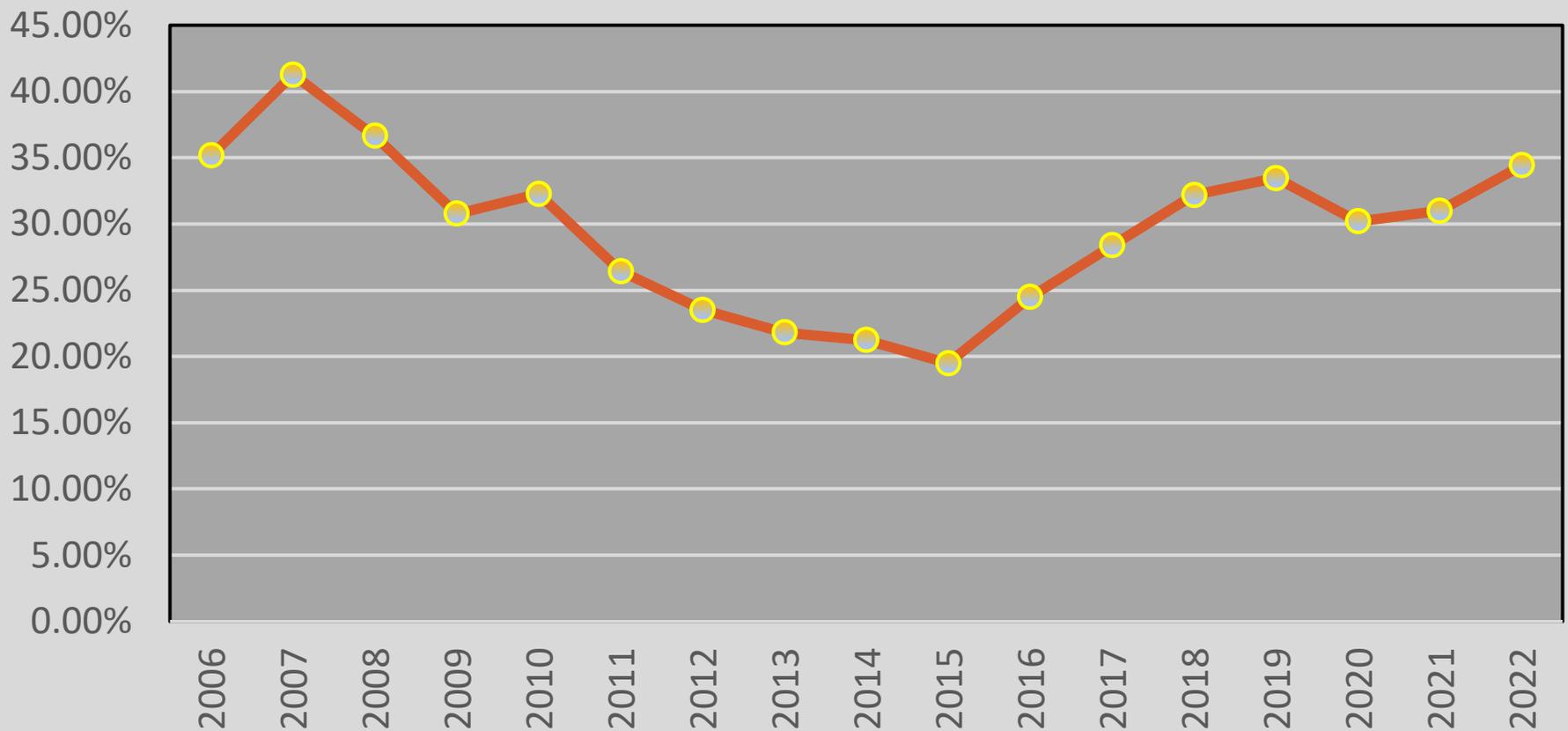
Earnings – You Really Want To Do That?

Industry Analysis: Intracompany Credits



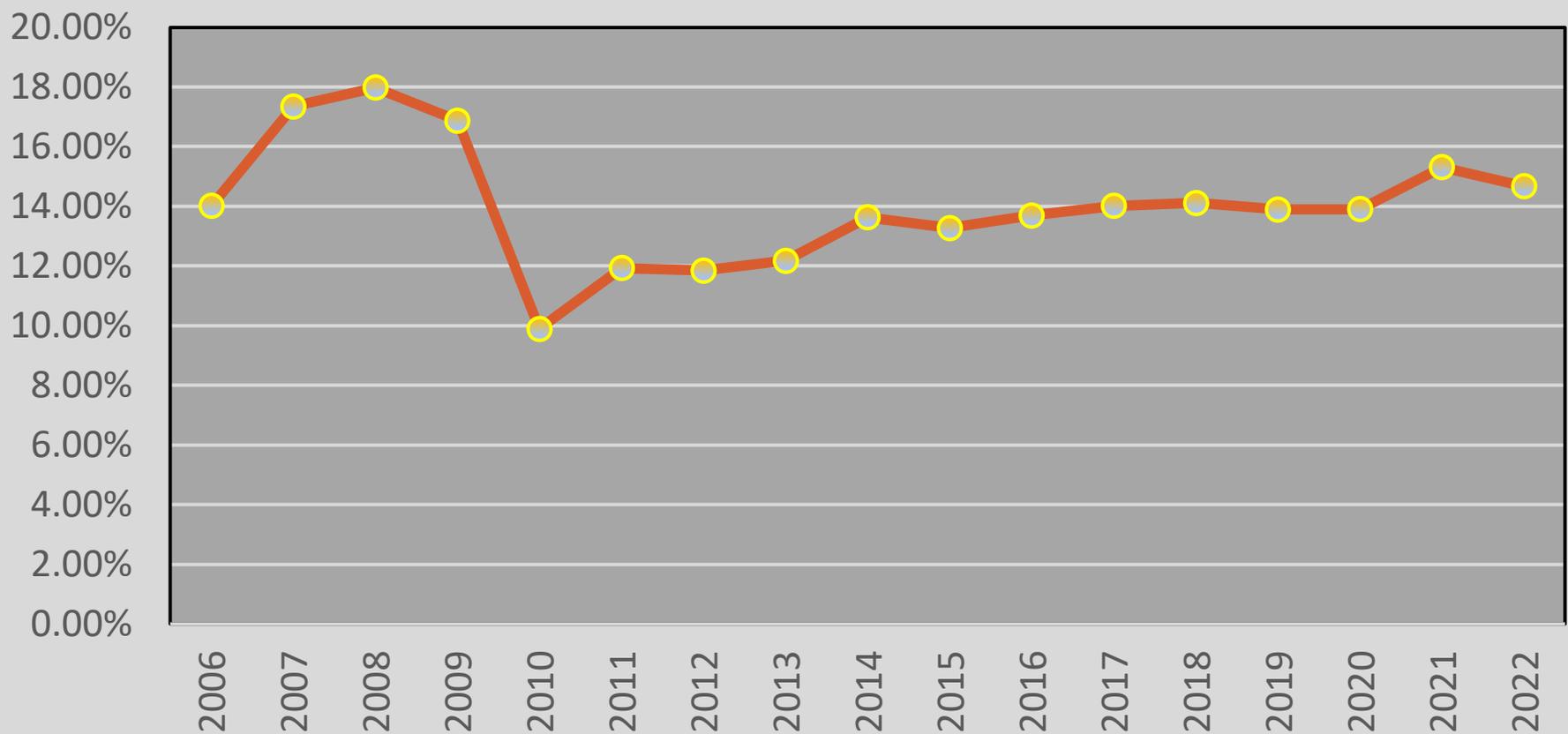
Earnings – You Really Want To Do That?

Industry Analysis: Profit Margin w/Intracompany Credits



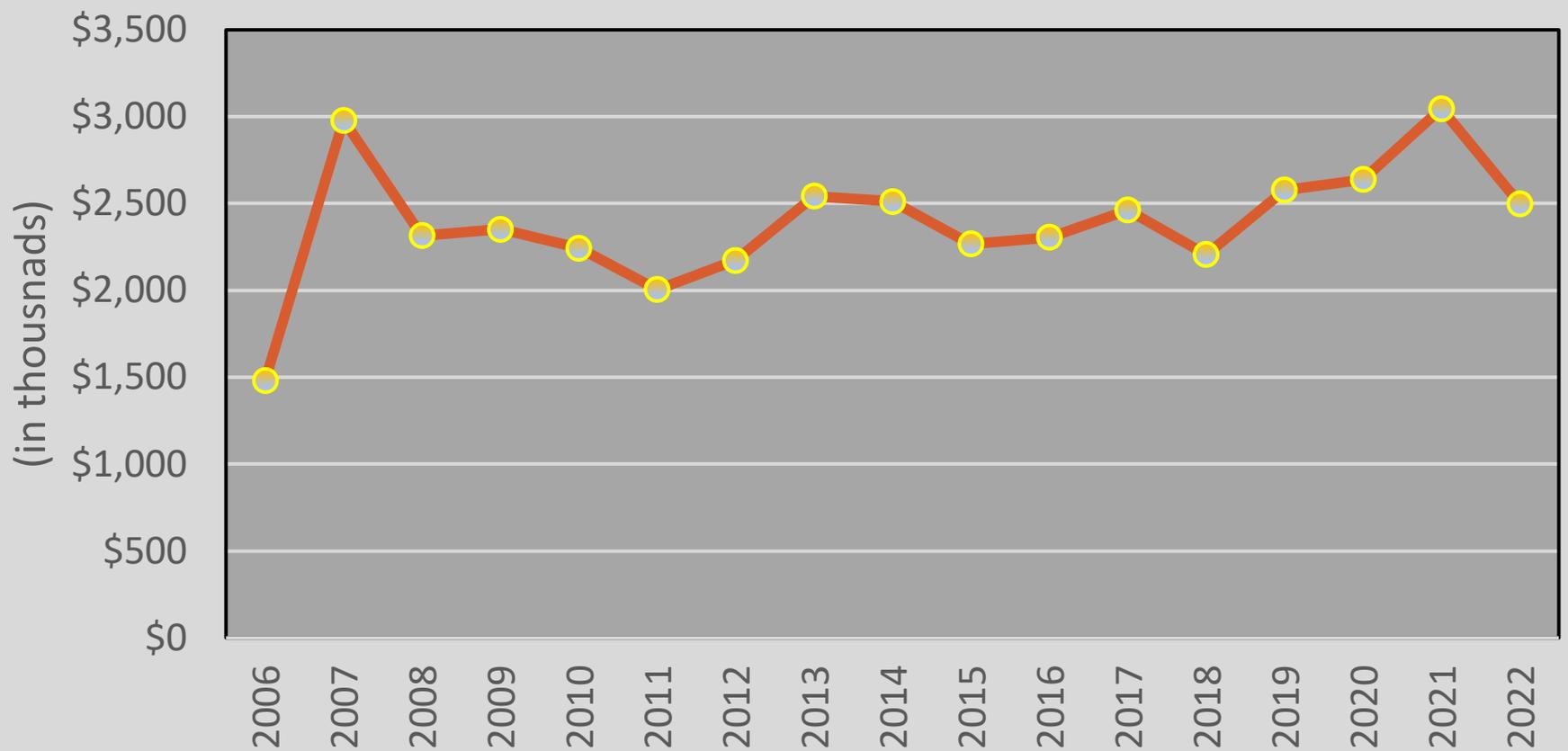
Earnings – You Really Want To Do That?

Industry Analysis: Fiduciary Income as a % of Non-Interest Income



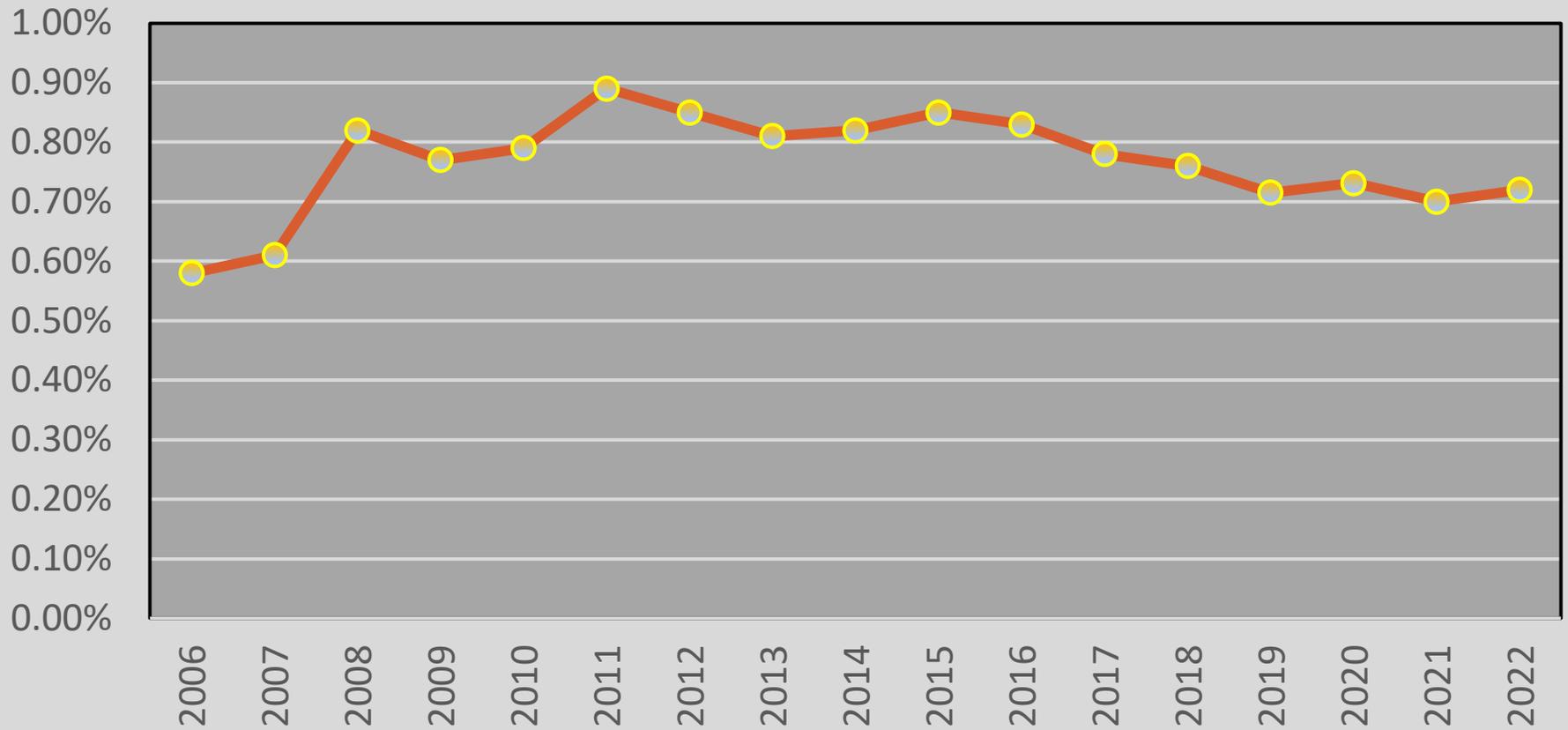
Earnings – You Really Want To Do That?

Industry Analysis: Average Account Size - Discretionary



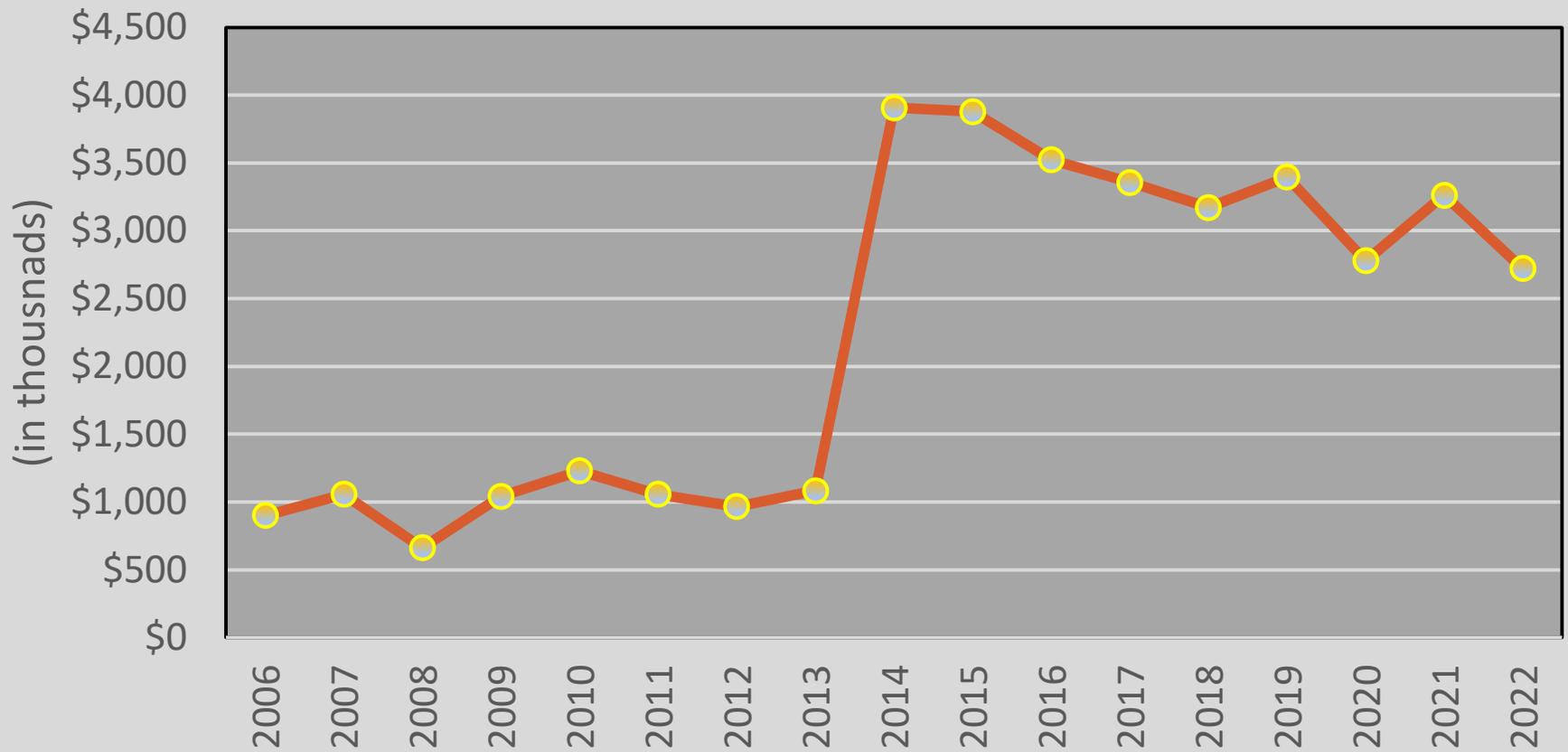
Earnings – You Really Want To Do That?

Industry Analysis: Return on Fiduciary Assets - Discretionary



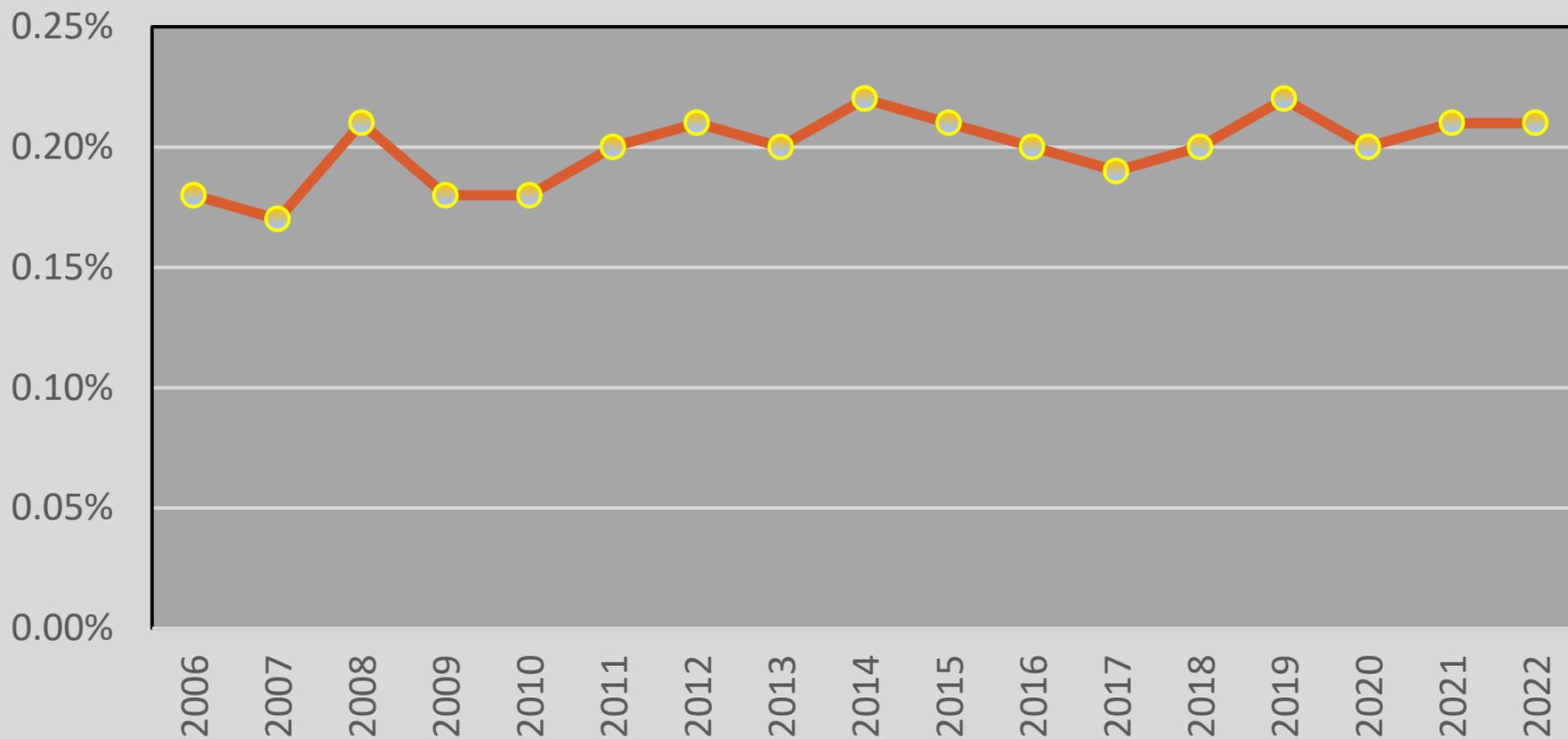
Earnings – You Really Want To Do That?

Industry Analysis: Average Account Size - Non-Discretionary



Earnings – You Really Want To Do That?

Industry Analysis: Return on Fiduciary Assets - Non-Discretionary



Revenue and Fees

- **Risk Statement**: Fees and revenue are insufficient to adequately manage the business resulting in staffing, client service issues and safety and soundness concerns. Insufficient information or poor reporting to the Trust Committee and Board results in poor decisions and initiatives. Revenue goals and objectives often based on expense reduction and not on revenue opportunities.

Reasonable
Compensation

Risk Causes: Inadequate and untimely setup of account fees, fee concessions and lack of adequate fee reporting to the board (ie. appropriateness of ongoing fee waivers and discounts).

Compliance

The institution's overall compliance with **applicable laws**, regulations, accepted standards of fiduciary conduct, governing account instruments, **duties associated with account administration**, and internally established policies and procedures.

- Compliance with **Applicable Law**
- Adequacy of Policies, Procedures, and Practices
- Systems and Controls for the Identification of Conflicts of Interest
- Adequacy of Securities Trading Practices
- Account Acceptance Decision Making Practices
- Account Administration Duties – **Discretionary Decisions for Account Beneficiaries**

Compliance

Principal and Income:

- Amortize the Premium
- Accrete the Discount
- Some States Relieve the Trustee
- Unique Situations - - - Are You Aware!

Compliance – Do You Really Want To Do That?

	Amortize a Premium	Accrete a Discount
• Bond Purchase Price	\$11,000	\$9,000
• Bond Face Value	\$10,000	\$10,000
• Years to Maturity	5	5
• Semi-Annual Coupon	\$500	\$500
• Premium/Discount	\$1,000	\$1,000
• Number of Payments	10	10
• Principal	\$100	(\$100)
• Interest	\$400	\$600

Compliance – Do You Really Want To Do That?



Compliance

Beneficiaries:

- Who are they?
- What do they need?
- When do they need it?
- When are they no longer a beneficiary?

Prudent Investor Act: Section 1

A trustee who invests and manages trust assets owes a **duty to the beneficiaries of the trust to comply** with the prudent investor rule set.

Compliance — Do You Really Want To Do That?

Beneficiaries:



Account Administration

- **Risk Statement**: Ineffective controls that ensure the provisions and articles of the trust instrument or contract establishing the relationship are properly managed. Inadequate or unskilled staffing of trust professionals who interpret and administer these provisions can lead to mismanagement of fiduciary accounts and possible misappropriation of trust funds.

Duty to
Administer
& Account

Risk Causes: Lack of board approved policies and procedures that are tailored to the size nature and complexity of the business. Inadequate staffing or unskilled trust professionals to accept accounts interpret provisions of the agreement. Inadequate governance and oversight of the business and key trusts requirements such as discretionary distributions of income and principal.

Documentation

Duty to Obtain
and Segregate
Records &
Furnish
Information

- **Risk Statement:** Poor file documentation and client correspondence can cause problems in account transitions, as well as lead to weak or no support during account disputes and/or litigation.

Risk Causes: Staff turnover and the focus on expense reductions and efficiencies has led to concerns in file documentation. While a tremendous amount of information can be captured in email, there remains weaknesses in the documentation of client phone calls and meetings, support for client direction including retention of off-list holdings and investment restrictions, co-trustee approvals of material account decisions, discretionary distributions etc.

Asset Management

The adequacy of effective management of risks associated with managing the assets of others. Prudent portfolio management is based on an assessment of the needs and objectives of **each** account or portfolio.

- **The decision-making processes used for selection, retention, and preservation of discretionary assets**
- Use of quantitative tools to measure the various financial risks
- Adequacy of procedures related to the **purchase or retention of unique and hard to value assets**
- **Extent and adequacy of periodic investment reviews**
- Use of Investment Policy Statements
- Monitoring of changes in the composition of fiduciary assets for trends and related risk exposure
- Due diligence process for evaluating investment advice received from vendors and/or brokers

Asset Management

The Decision-Making Processes for Account Assets

- Knowledge of the Account Objectives
- Accurateness of the Investment Policy Statement
- Awareness of All Beneficiaries
- Communication with All Interested Parties
- Understanding Governing Instrument Language
- Establishment of a Process and Consistent Application
- Committee Involvement

Asset Management – You Really Want To Do That?

The Decision-Making Processes for Account Assets

<u>Situation</u>	<u>Options / Alternatives</u>
<ul style="list-style-type: none">• \$1.5 Million	1.
<ul style="list-style-type: none">• Mom's Account	
<ul style="list-style-type: none">• Ascertainable Standards – HEMS	2.
<ul style="list-style-type: none">• Principal Distributions	3.
<ul style="list-style-type: none">• Income Distributions	
<ul style="list-style-type: none">• General Powers	4.
<ul style="list-style-type: none">• Revocable	
<ul style="list-style-type: none">• Beneficiaries – D1, D2, & S1	5.

Asset Management – You Really Want To Do That?

The Decision-Making Processes for Account Assets

<u>Situation</u>	<u>Options / Alternatives</u>
<ul style="list-style-type: none">• \$1.5 Million• Mom's Account• Ascertainable Standards – HEMS• Principal Distributions• Income Distributions• General Powers• Revocable• Beneficiaries – D1, D2, & S1	<ol style="list-style-type: none">1. Do It2. Decline (Resign)3. Distribute4. Decant5. Don't Do It

Asset Management – You Really Want To Do That?

Purchase / Retention of Unique Assets



Asset Management

Extent and Adequacy of Periodic Investment Reviews:

§ 9.6 Review of Fiduciary Accounts

- a) ***Pre-acceptance review.*** Before accepting a fiduciary account, a bank shall review the prospective account to determine whether it can properly administer the account. (10-P's)
- b) ***Initial post-acceptance review.*** Upon the acceptance of a fiduciary account for which a 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.
- 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.

Asset Management

Extent and Adequacy of Periodic Investment Reviews:

- **The 10-P's of Account Acceptance and Review**

- Place (Situs)
- Purpose (Intent)
- Provisions (Instrument)
- Principles (Interested Parties)
- Potential Conflicts
- Performance (Administrative Responsibilities)
- **Portfolio**
 - **Current**
 - **Future**
- Processing Requirements
- Pricing
- Profitability

Asset Management – You Really Want To Do That?

ALL Means ALL

Account Acceptance Process

- **Risk Statement**: Marginal and/or ineffective account acceptance processes, including policies, procedures, and oversight provide and environment for increased risks. Account acceptance procedures are inadequately designed to ensure accounts with difficult to manage terms or insufficient expertise can lead to improper administration and hard to manage accounts. Accepting assets that are difficult to manage or high risk can result in environmental issues or costly asset management and custody issues.

Duty to
Exercise
Reasonable
Care & Skill

Risk Causes: The generation of new business remains paramount to the viability of the business. As such, account sales goals have been increased and additional pressure has been placed upon the unit for account growth. As a result Account Acceptance processes may be compromised. In addition, poor or ineffective policies, procedures and oversight result in increased risk with new accounts. Inadequate account opening policies and procedures including initial account acceptance, document review for terms and conditions, initial review of assets for proper administration and consistency with investment objectives and inadequate collection of account opening documentation.

Investment of Fiduciary Assets

- **Risk Statement:** Lack of controls and adequate oversight of Investment Management practices can lead to improper investment strategies, client and beneficiary objectives not being met and possible litigation and regulatory concerns. Also, allowing cash to go uninvested or underinvested for an inordinate amount of time can lead to concerns over the proper administration of accounts and/or regulatory concerns and potential performance issues and shortfalls for income beneficiaries and account expenses.

Duty to
Invest and
Generate
Reasonable
Income

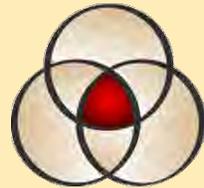
Risk Causes: Simple lack of understanding of the investment objectives of the Grantor and/or beneficiaries; Inadequately documenting accounts to ensure they are invested appropriately; Lack of documented direction to hold Off-List and unique assets; Lack of understanding the account's Income & Principal requirements; Lack of regular communication with clients on changing family dynamics and needs; Not executing customer or co-trustee direction; Lack of performing initial and ongoing investment reviews and portfolio realignment; Inadequate due diligence over third-party investment managers; Lack of proper investment strategy for initial investment or periodic account enrichments; Not activating internal sweep vehicles; Inadequate communication between Business Development, Administration and Investment staff; Utilizing own bank deposit products and not performing adequate review of comparable money funds or other temporary investment vehicles.

Unique Assets

- **Risk Statement**: Operational and compliance risk is increased when unique assets are not properly recorded, administered, and controlled. Unique assets must be included in the account objective decisions and ongoing administration. Proper pricing is needed to ensure that regulatory reports are accurate and correct. Valuation standards are needed for consistency. Administrative procedures need to be specific to each type of unique asset. Summary reports are needed to ensure a thorough understanding of the assets held and their value.

Duty to Take
Control of
Trust
Property

Risk Causes: More accounts are being accepted that contain unique assets, including Real Estate, Closely Held Businesses, LLCs, Partnerships, notes and mortgages, life insurance policies, and other unique holdings. In addition, the OCC Handbook for Special Assets came out in August of 2012 and increased attention is being given to this area.



Bearmoor, LLC

Asset Management and Fiduciary Consultants

Thank You!

Discussion Time
Agree – Disagree
Comments

Don Moore

Bearmoor, LLC

dmoore@bearmoor.com

719.839.0860