

This document and any attachments are superseded by Comptroller's Handbook - Asset Management.

Introduction to Real Estate Interests

This section will cover two types of interests: real estate and real estate loans. While holdings of these assets do not typically constitute a large percentage of total account holdings, their specialized nature and often complex characteristics make them deserving of special attention. In order to properly administer real estate interests, the savings association must have specialized and expert knowledge and must pay particular attention to operational and administrative duties. These requirements should be carefully considered prior to making any decision to retain or purchase real estate interests.

Real Estate

Various types of real estate can be held in fiduciary accounts, including personal residences, residential income properties, commercial properties, unimproved acreage, vacant lots, timberland, farm or ranch land. Management should be familiar with all aspects of real property administration, including purchasing, leasing, improving and repairing before undertaking the administration of significant holdings. Due to the variety and complexity of these assets, the savings association should have policies and procedures addressing real estate interests. There are several basic steps that should be followed to assist in minimizing any potential problems that can arise in connection with the administration of real estate. These steps are outlined below:

- The savings association should ensure that it possesses valid and clear title to any property held, whether received in kind or purchased. The best time to remedy defects in the title is when the interest is being acquired. Defects in title can delay a proposed sale and possibly defeat the transaction.
- The savings association should have a program of appraisal and periodic inspection of all real estate held in accounts where it has investment responsibility.
- The savings association should ensure that purchase or retention of real estate is appropriate for meeting the account objectives.
- There should be an effective process for the administration of real estate. Such a process would ensure that adequate insurance is kept current, property taxes are accurate and paid when due and that special requirements are monitored, such as collecting rents, inspecting crops or conducting repairs.

In all but a few states a fiduciary is prohibited from holding title to real estate unless it is qualified to do business in that state. In those cases, a fiduciary holding real estate in an account should appoint an ancillary fiduciary or agent to administer the property. Therefore, the department should have procedures to address any local law requirements in other jurisdictions regarding title to and management of real estate with an out-of-state location.

The savings association should have a program of appraisal and inspection of all real estate held in accounts where it has investment responsibility. It is an accepted fiduciary principle that the fiduciary should possess current information as to the value and condition of properties for which it is responsible. This information is needed in order to make an informed purchase, sale or retention decision. Prudent investment policy would dictate that appraisals and inspections be performed prior to or promptly after acceptance of real estate, and prior to any purchase. Thereafter, appraisals should be made at least every three years for properties held in personal trust accounts. Properties held in employee benefit accounts should be appraised annually to satisfy the regulatory requirements of ERISA. A savings association should use discretion within

these parameters. For example, appraisals or inspections for some types of property should be made more frequently, such as commercial office buildings, while appraisals or inspections for other types may be done less frequently, such as the owner's residence or vacant land. Similarly, property under active management should be appraised or inspected more frequently than fractional interests in real estate where the savings association has no effective control.

Qualified and independent personnel should perform appraisals and inspections. Such personnel can be either internal or external. In either case the appraiser/inspector should be knowledgeable and have expertise in the type of property being appraised. The appraiser must also be independent from the transaction and property being appraised.

Where the savings association has investment responsibility, real estate should only be purchased or retained when it is appropriate for an account. The following is a partial list of the factors that should be considered in making an investment decision pertaining to real estate:

- Authority in the governing instrument or elsewhere to purchase, retain, or sell real estate
- Suitability of the investment for the particular account
- Current appraisal of value, its future marketability, prospects for future appreciation/depreciation in value and cash flow
- Yield potential
- Tax benefits
- Assessment of risk factors, including environmental liability
- For leased property, terms of leases and creditworthiness of tenants
- Costs associated with real estate (taxes, insurance, maintenance, etc.) compared to other investment alternatives

Environmental Liability

Management should ensure that environmental risks are assessed prior to asset acceptance, including compliance with federal and state environmental law. Congress enacted the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), as amended by the Superfund Amendments and Reauthorization Act of 1986, to govern financial responsibility for cleaning up toxic waste. CERCLA is generally considered to be the primary environmental cleanup and liability law. Savings association should note that the Asset Conservation, Lender Liability and Deposit Insurance Protection Act of 1996 affords to lenders and fiduciaries liability relief from Section 107 of the CERCLA. Under §2502(a) of the Act, the liability of fiduciaries is limited to the assets held in their fiduciary capacity. Trustees will be found liable for the costs of environmental cleanups only if their negligence “causes or contributes” to the release of a hazardous substance on properties they hold in trust. Under new §107(n)(4) of CERCLA, fiduciaries do not face personal liability if they stay within the enumerated “safe harbors” of subsection (4) of Section 502. The legislation added a section to 42 U.S.C.A. §9607.

Real Estate Loans

Real estate notes and mortgages are most often received in kind as a result of the settlor having used them to facilitate the purchase and/or sale of real property. These interests may also be acquired as a result of the sale of real estate from an account in return for a mortgage or purchased outright. Most real estate loans are held in personal and employee benefit accounts which also hold a substantial portion of real estate itself or in employee benefit accounts where residential loans are made to participants in the account, up to their vested interest.

There are both advantages and disadvantages to investing in real estate loans. Real estate loans that are appropriate for the account and adequately secured are considered to be prudent investments and can be used to enhance a portfolio's overall return. In most instances real estate loans are considered to be safe investments because of adequate collateral coverage. On the other hand, individual real estate loans usually are not readily marketable. In addition, it is not unusual for the quality of loans received in kind to be below that which a fiduciary would make on its own. Therefore, it is very important to have full documentation for all actions pertaining to real estate loans. Also, a major source of concern regarding real estate loans is when these assets become delinquent. Losses due to delinquencies are not limited to financial loss but also include the loss associated with expending resources to attempt to collect on loans and/or initiate foreclosure proceedings. To protect against possible loss, the savings association should have written policies and procedures that address the administration and supervision of delinquent real estate loans. Such policies should address the following:

- monitoring timely payment of outstanding balance;
- ensuring that delinquencies are tracked and corrected in a timely manner;
- reporting delinquencies to an appropriate level and/or committee;
- inspecting the property to forestall unknown deterioration and preserve value if foreclosure appears necessary; and
- establishing a plan for foreclosure.

The institution should have a system of internal controls to sufficiently monitor periodic but recurring activities such as loan, tax and insurance payments. These controls should consist of a tickler system and management information reports. Also, the discussion in the real estate subsection above concerning ancillary administration, insurance, appraisal and inspections is also relevant to real estate loans.

A fiduciary may also invest and participate in pools of real estate mortgages. Participation in mortgage investments enables the fiduciary to maintain portfolio diversity and reduce administrative costs. The individual fiduciary account and aggregate interest in these investments must be properly controlled. In the event of default, the savings association should determine that the participation agreements provide that each account bears only its pro rata share of loss. If such investments are purchased from an affiliate, the savings association should make sure that the inherent conflicts of interests involved are addressed, that the investment is prudent for the account and that the OTS's transaction with affiliates regulations are considered.

When making investment decisions concerning real estate loans, the institution should consider:

- value of the underlying parcel of real estate held as collateral;

- acceptable ratio of loan amount to current appraised value of the real estate;
- ability of the borrower to repay, including an analysis of the credit history;
- adequacy of the interest rate;
- documentation necessary to establish priority of lien and validity of loan; and
- adequacy of title insurance on the underlying real estate.

Mineral Interests

Mineral interests can be broadly defined as the property interest created in oil, gas or other minerals after severance by deed or lease and may exist for a fixed number of years, for a certain life or forever. Owners of mineral interests have the legal right to enter the property in order to explore, drill or carry on other similar activities. They also have the right to grant leases and assign all or part of their interest to others. There are different types of ownership interests in these types of assets that may be held in fiduciary accounts, including working interests and royalty interests. Trustees must properly manage oil, gas and mineral properties just as they administer all other types of assets held in fiduciary accounts. In most cases these assets would have been deposited in kind, rather than purchased by the savings association. The trust department must be fully familiar with these interests and employ outside expertise when necessary.

A mineral interest can be defined as the sum of all rights to oil, gas or minerals on a property. Owners of mineral interests have the right to explore and drill on the property. They also have the right to grant oil and gas leases and are entitled to any lease bonus or delay rental that may be payable in connection with the lease. Mineral interest owners may assign all, a segregated portion or an undivided fractional share of their interest. When such assigned rights are limited in duration they are called "term minerals" while an assignment that is not limited is referred to as "perpetual minerals".

A royalty interest is an interest in the underlying oil and gas reserves which is retained when an owner of land grants to another the right to determine the existence of commercial quantities of oil and/or gas on the property. In other words, a royalty interest is a mineral interest that does not have the rights and responsibilities of developing the property. A working interest is a mineral interest minus the royalty interest. The working interest is burdened with the cost of developing the property and the responsibility of operating the activity. The breakdown of ownership interests and payments is outlined in the division order. The most generally accepted fraction of mineral interest production is 1/8 to the royalty interest and 7/8 to the working interest. The fiduciary should carefully review and understand the provisions of the division order.

In the administration of oil, gas and mineral interests, the savings association should have written policies and procedures for proper supervision and administration. As is the case with other types of specialized assets, the potential for increased risk, liability or loss is directly related to the degree of experience and expertise available. Detailed and adequate record keeping is essential for proper administration. Each interest held in a fiduciary account should be thoroughly reviewed and documented. Important provisions should be very closely monitored to provide assurance that no event will occur without prior knowledge of the fiduciary. A monitoring system should include:

- type of interest owned;
- fractional share of interest owned and division orders;
- title records;

- description of the type of property leased;
- terms of the lease, including expiration date;
- name and address of lessee;
- amount of delay rental;
- date rent is due, and
- bonuses

Due to the unique nature of mineral interests, the fiduciary may have problems properly monitoring such assets. Since valuations of mineral interests can be difficult, the savings association may wish to employ outside consultants, such as qualified geologists, landmen, engineers and accountants to determine the valuation and tax treatment of the mineral interest. Also, the savings association should keep in mind that mineral interests are considered illiquid and can provide irregular income so it may be difficult to base income payments to beneficiaries on this type of asset.

Significant costs may be incurred by the fiduciary in the administration of mineral interests. The savings association should take additional costs into consideration when charging fees for their administration. These fees should be reviewed and approved by the board of directors and be disclosed in the fee schedule for fiduciary services.

Real Estate Interests Examination Program

Examination Objectives

To determine the adequacy and/or effectiveness of the trust department's administration of real estate interests. Consider whether management:

- has a full understanding of the scope and nature of responsibilities for real estate interests held;
- has established adequate and effective policies, procedures and internal controls for the administration of real estate interests;
- has provided for quality administration of real estate interests by ensuring adequacy of available expertise;
- monitors compliance with governing instruments, applicable law and accepted fiduciary principles; and
- initiates prompt corrective action when violations of governing instruments, applicable law or accepted fiduciary principles have been noted or when policies, procedures or internal controls are deficient.

Examination Procedures

Wkp. Ref.

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 new products and/or services have been introduced. If items of concern are uncovered during a Level I procedure or if problems are identified during the preexamination monitoring and scoping, the examiner may need to perform certain Level II procedures.

1. Review examination scoping materials related to the management of real estate and mineral interest investments. 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
- Board of director and other applicable committee minutes
- Examination reports of subordinate functionally regulated entities

2. Evaluate the trust department's policies and procedures related to real estate interests. Review all significant changes to policies, procedures and practices. Consider the following items:

- How compliance with applicable law or standards of fiduciary conduct is ensured
- Preacceptance guidelines that address environmental and other risks associated with real estate interests
- Documentation requirements to support the appropriate administration of real estate and mineral interests contained in customer accounts, including: clear title; inspections and appraisals; acquisitions and disposals; rental, lease or property management; insurance requirements; taxes; ongoing monitoring; or other pertinent issues
- Required knowledge and expertise of management
- Delegation of real estate management and/or interests to third parties
- Authority and approval levels for exceptions to policy

3. Evaluate whether management has the necessary expertise to effectively administer real estate interests. Determine if any significant personnel and/or organizational changes (including changes in outside property managers) have occurred.

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4. Review a summary of real estate interest holdings in discretionary accounts. Determine that the policies and procedures have been established to adequately address the specific characteristics of each type of real estate interest held, including: personal residences; residential income properties; commercial properties; vacant land; property under construction; timberland, farm and ranch land; real estate loans; and mineral interests.
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5. If administration of real estate interests is delegated to third parties, assess the selection and oversight process.
-
6. If there are material unresolved exceptions present from internal or external audit reports, compliance reports or examination reports, determine and evaluate the reasons for their presence. Evaluate management's plan to correct the exceptions.
-
7. Is the trust department accounting system adequate to handle real estate and mineral interests?
-
8. Are policies adequate to ensure that there is no leasing of mineral interests to savings association insiders, affiliates or their related interests?
-
9. Are fee schedules periodically reviewed to reflect appropriate charges for special services involving real estate and mineral interests?
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10. Consider whether the following risk contributors (if applicable) have been addressed:
- Does management fully understand all aspects of risk related to real estate investments?
 - Do policies and procedures address all significant activities?
 - Is management qualified to administer real estate interests?
 - Do management information systems and reports provide credible and comprehensive information?
 - Is the internal control environment adequate?
 - Are controls over outsourcing arrangements adequate?
 - Are environmental concerns properly managed?
 - Does management quickly identify weaknesses and take appropriate action?
 - Are there unresolved issues noted in audit, compliance or examination reports?

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.

1. If agents are employed to manage real estate interests:

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- Are the qualifications and experience of the agent reviewed prior to employment?
 - Are the duties and responsibilities of the respective parties adequately set forth in a written agency agreement, including provisions relating to content and frequency of reports, authority to incur and pay expenses and compensation?
 - Is the agent's performance periodically evaluated?
-
2. Review and verify the accuracy of any applicable management exception reports.
-
3. Determine if the management systems are capable of monitoring and controlling income receipts, disbursements of expenses or other recurring activities.
-
4. Determine if appraisals are in accordance with state law or department policy.
-
5. Are appraisals and inspections made in accordance with trust department policy and are they performed by qualified and independent parties?
-
6. Evaluate how management handles environmental issues?
-
7. Evaluate the factors considered if management decides to purchase, retain or sell real estate loans. Are the factors considered adequate?
-
8. Does the payment of real estate taxes and insurance premiums receive prompt attention?
-

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9. Does the savings association ensure that proper evidence of title is obtained for oil or mineral holdings, such as the deed, division order or assignment of interest?
-
10. Have all lease forms and other legal documents required to hold title to various mineral interests been reviewed by legal counsel?
-
11. 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.
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If the examiner cannot rely on the trust and asset management Level I and 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 directed accounts that hold real estate interests and determine that proper authorization exists, such as a current direction letter.
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2. Determine that the trust department is qualified to conduct business in the state where the real estate is located or that an ancillary fiduciary or agent has been appointed to administer the property.

3. Select a sample of different types of discretionary real estate interests for a detailed account review and determine whether real estate interests held are of trust quality and otherwise suitable for the accounts. If not considered suitable, determine what efforts are being taken to dispose of the interests. Determine the presence of the following:

- all relevant factors were considered prior to purchasing any interest in real estate and in the decision to retain any interest in real estate, including the investment objective of the account, yield on the real estate and tax implications;
- sufficient documentation is on file to support the investment decision and to support the proper administration of the account;
- clear and valid title has been obtained;
- proper authorization for purchasing or retaining any real estate interest is present in the governing instrument or other specific authorization;
- receipts showing current payment of taxes and insurance premiums are on file;
- copies of leases, rental agreements or documents pertaining to the specialized administration of particular properties are present;
- copies of inspection and appraisal reports are on file;
- environmental risk assessments, if applicable, have been performed; and
- all income and expenses are clearly documented and authorized.

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4. Determine if accounting records provide a trail of revenue and expense entries for mineral interests as well as sufficient tax information.

5. Compare any deficiencies noted during the account reviews and determine if the findings of the audit/compliance review are consistent with examination findings. If not, determine the reason for any discrepancy.

Examiner's UITRS Rating, Summary, Conclusions and Recommendations:

References - 850P

Laws

ERISA Section 407
 CERCLA

Code of Federal Regulations

Office of Thrift Supervision Publications

TB 76-2 Conflicts of Interest Relating to Fiduciary Activities

Other

Scott on Trusts, 3rd Edition
 Bogert and Bogert, Trust and Trustees, 2nd Ed.
 Restatement (Second and Third) of Trusts

Workpaper Attachments - 850P

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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

Do the policy and procedures:
<ul style="list-style-type: none">• Before acceptance, require that holdings are reviewed and physically inspected to identify potential environmental liability or exposure?
<ul style="list-style-type: none">• Ensure clear title is obtained upon receipt of the property?
<ul style="list-style-type: none">• Require that essential documents, such as deeds, mortgages, insurance policies, contracts for sale, tax receipts, etc. are obtained?
<ul style="list-style-type: none">• Require appraisals and inspections, including the need to have updated values?
<ul style="list-style-type: none">• Require procedures for determining when ancillary trustee services will be required?
<ul style="list-style-type: none">• Address foreclosure practices?
<ul style="list-style-type: none">• Address effective rental and lease agreements or contracts?
<ul style="list-style-type: none">• Address qualifications of the real estate agents and managers used to manage property?
<ul style="list-style-type: none">• Require that fees paid to third parties are reasonable in relation to services provided?
<ul style="list-style-type: none">• Address tickler systems for tracking receipt of rental and lease payments and monitoring of delinquent payments?

Property Conveyance

Are the following documents on file:
<ul style="list-style-type: none">• Original purchase and conveyance documents showing evidence of title (contract of sale (real estate); deed (real estate, real estate loan, mineral interest); note or mortgage (real estate loan); division order or assignment (mineral interest)?
<ul style="list-style-type: none">• An updated appraisal report from a qualified individual?
<ul style="list-style-type: none">• Title insurance or other documentation considered necessary to demonstrate clear title?
<ul style="list-style-type: none">• Insurance policies (e.g., for property or liability coverage), and current paid receipts?
<ul style="list-style-type: none">• Property tax receipts?
<ul style="list-style-type: none">• Any other information pertinent to the interest (leases, mortgages, liens or releases (real estate); documents relating to security and collateral (real estate loan); leases, licenses, permits, operating agreements (mineral interest))?

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Appraisals and Inspections

Are appraisals and inspections:
<ul style="list-style-type: none">• Performed by qualified and independent personnel?
<ul style="list-style-type: none">• Obtained prior to purchase?
<ul style="list-style-type: none">• Made in accordance with, as applicable, state law or governing instrument requirements, trust department policy or sound fiduciary principles?

Real Estate Administration

Are the following items monitored and controlled:
<ul style="list-style-type: none">• Adequate insurance is maintained in accordance with, as applicable, state law or governing instrument requirements, department policy or sound fiduciary principles?
<ul style="list-style-type: none">• Payment of real estate taxes?
<ul style="list-style-type: none">• Payment of insurance premiums?
<ul style="list-style-type: none">• Collection of rent or other income?
<ul style="list-style-type: none">• Payment of expenses?

Mineral Interests

Are all the following relevant factors considered prior to purchasing or retaining any mineral interests?
<ul style="list-style-type: none">• The status of the interest received (such as whether it is leased, producing or nonproducing, its location, etc.)?
<ul style="list-style-type: none">• Is the department's accounting system adequate for handling mineral interests?
<ul style="list-style-type: none">• Are interests leased only in accordance with standardized procedures which address such items as the following:<ul style="list-style-type: none">• The form of lease agreement to be used.• Fees to be charged.• Responsibility for maintenance of insurance coverage.• Counsel or an appropriate committee reviews lease agreements prior to execution review.• The department maintains a system to monitor and control the following:<ul style="list-style-type: none">▪ Lease and royalty payments, including delinquencies.▪ Delayed rental payments on nonproducing interests.▪ Expiration of leases and insurance.▪ Receipt of income, including expected due date.▪ Disbursement of expenses.

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|--|
| ▪ Any other special or recurring activities. |
| • Are guidelines in effect to avoid leasing mineral interests to employees of the savings association and other related parties? |

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