

Trust Company	Enter Name and City	Date of Exam	
Charter #		Prepared By	

#8 – ASSET QUALITY (Risk Focused)

ASSIGNMENT OVERVIEW:

The asset quality rating reflects the quantity of existing and potential credit risk associated with the investment portfolios, loans, other real estate owned, and other assets, as well as off-balance sheet transactions. The ability of management to identify, measure, monitor, and control credit risk is also reflected here. The evaluation of asset quality should weigh the exposure to counterparty, issuer, or borrow default under actual or implied contractual agreements and consider the adequacy of the allowance for loan and losses. All other risks that may affect the value or marketability of an institution’s assets, including, but not limited to, operating, market, reputation, strategic, or compliance risks, should also be considered.

INSTRUCTIONS:

Examiners must follow the requirements in the Examiner Bulletin addressing Guidelines for Procedures and Work Paper Documentation for Trust Examinations.

All examiners performing these procedures must be listed above in the “Prepared By” section. Comments and findings for each step should be made in the comment box below each question. Reference to work paper documentation should also be included here. Documentation is to be sufficient to allow an audit trail of the examiner’s thought process and all significant findings. Items to Consider within the core analysis are not required to be commented on unless there are significant issues. The intent is to assist the examiner in expanding their thought process and analysis of that particular area.

Based on any significant/critical findings in the CORE ANALYSIS or as directed by the EIC, the applicable SUPPLEMENTAL ASSESSMENT PHASE (SAP) should also be performed. **Responses should be entered in the SAP. Conclusions** should be added to the corresponding CORE ANALYSIS comment section.

Information on the Summary of Findings page must tie back to the findings noted within the procedure. The SEIC/EIC will determine which information in the Summary of Findings will be included in the Report of Examination.

The EIC/AEIC should review this procedure when complete. Acknowledgement that this procedure has been reviewed by the EIC/AEIC will be indicated on the SCOPE FORM.

EXAMINERS ARE RESPONSIBLE FOR EXERCISING SOUND JUDGMENT AND UTILIZING REASONABLE INVESTIGATIVE AND ANALYTICAL SKILLS TO ARRIVE AT AN ACCURATE ASSESSMENT OF THE RISK PROFILE OF THIS SEGMENT OF THE INSTITUTION’S OPERATIONS. PERFORMING ALTERNATE PROCEDURES NOT LISTED WITH THESE GUIDELINES MAY BE NECESSARY TO COMPLETE THIS RISK ANALYSIS.

CORE ANALYSIS

#8 ASSET QUALITY

1. Prior Criticism

1a. Determine whether deficiencies noted in the last examination and most recent internal/external audit have been addressed and/or corrected by management. Detail how deficiencies were corrected. *Include a copy of audit exceptions and/or prior examination criticisms and management response in work papers or indicate the page number in the prior report of examination where the deficiencies are noted, or summarize exceptions/criticisms below, if applicable.*

Comments:

2. Reconciliation

2a. Review the Call Reports submitted since the last examination:

- a) Balance and reconcile the assets to the Call Report schedules RC-Balance Sheet, RC-A, RC-B, and RC-C. *Include copy of reconcilements in 8-B of work papers.* If any material differences (generally, more than 1% of total assets) are noted between general ledger and Call Report, notify the EIC.
- b) Review the signed Call Report attestation pages from the last examination. The signature page must be signed and dated by an executive officer and two directors per Texas Administrative Code (TAC) [§17.23\(d\)](#).

Comment on noncompliance and any deficiencies.

Call Report Balances and Reconciles?	Select Response
Call Report signature page complies with <u>TAC §17.23(d)</u> ?	Select Response

Comments:

2b. If there has been less than a full scope audit of the bank's financial statements in the last 12 months:

- Obtain subsidiary ledgers of all premises and equipment accounts and
- Reconcile to the general ledger.

Comment on any deficiencies.

Full Scope Audit in last 12 months?	Select Response
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Comments:

#8 ASSET QUALITY

2c. Utilizing the Call Report, evaluate any substantial or material changes in the makeup or composition of the balance sheet. Comment on why the changes occurred, whether they are suitable practices, and how they impact the trust company.

Comments:

3. Review and Analysis

3a. Review the last three months cash and cash equivalent statements. Trace significant and unusual items to final disposition to determine appropriateness. *Comment on any findings.*

Comments:

3b. Determine if the trust company has intangible assets. If applicable, consider the following:

- 1) Review calculations of intangibles to determine if values are reasonable and justified.
- 2) Ensure the intangibles are being amortized correctly. (Refer FASB ASC Topic 350-Intangibles – Goodwill and Other (formerly FASB 142) and Call Report Instructions-Glossary, Business Combinations.).
- 3) Determine if the value of Goodwill is tested for impairment at least annually. If an impairment of value has occurred, the asset must be written down to reflect its diminished value. (Refer to ASC Topic 350 for guidelines for impairment testing.) *Include copy of impairment testing in workpapers.*

Refer to [Appendix I](#) for additional guidance.

Does the trust company have Goodwill Assets?	Select Response
Does the trust company have Other Intangible Assets?	Select Response

Comment:

3c. If the trust company booked any deferred tax asset as a result of Net Operating Losses, address the following:

- 1) Determine if the amount in deferred tax assets is reasonable and realizable by reviewing the trust company’s calculation **performed by their accountant**. Net deferred tax assets, which can be realized from taxes paid in prior years and from the future reversal of temporary differences, are not specifically limited by regulatory authorities; however, the amount booked should not exceed taxes previously paid which can be recovered through net operating loss (NOL) carry backs.
- 2) Verify if management reassesses the value of the net deferred tax asset account at least annually and

#8 ASSET QUALITY

adjusts accordingly.

3) If any excessive amount is identified, verify that the trust company either established a valuation allowance account for any temporary difference or charged off any excess amount.

Does the trust company have deferred tax assets?
If yes, comment below.

Select Response

Comments:

3d. Determine the validity and benefit of any other asset account including suspense accounts. If there is a large concentration of other assets, or unusual items or activity, further review may be appropriate. Comment on any deficiencies noted.

Consider the following:

- 1) Items included in suspense accounts should be periodically aged and reviewed for propriety by responsible personnel.
- 2) Proper adjustments should be made periodically to clear this account to zero.
- 3) Stale items held in the account that are more than 30 days old should be considered for charge-off.
- 4) Material items posted to the account.
- 5) A series of transactions or a single day aggregating a material amount.
- 6) Stale items as determined to be significant.

*Note: For accounts with high activity a random sampling of transactions may be appropriate. Document the method used to determine the sample.

Comments:

3e. Determine if the trust company's investment in facilities (facilities, furniture, fixtures, and equipment.) does not exceed the restricted capital level and is in compliance with Texas Finance Code (TFC) §[184.002\(a\)](#).

In addition, if there is future expansion property, determine compliance with TFC §[184.002 \(b\) and \(c\)](#). If applicable, determine compliance with Compliance with 7 TAC §[19.51](#) regarding other real estate.

Investment in facilities complies with TFC §[184.002](#)

Select Response

Investment in future expansion property complies with TFC §[184.002\(b\) and \(c\)](#)

Select Response

#8 ASSET QUALITY

Compliance with 7 TAC § 19.51 regarding other real estate	Select Response
Comments:	
<p>3f. Determine if the trust company is in compliance with TFC §184.101 which requires that a state trust company must invest and maintain an amount equal to at least 50% of their restricted capital in investment securities that are readily marketable and can be converted to cash within four business days. A lesser amount or time extension, for good cause shown, must be approved in writing by the banking commissioner.</p>	
Investment in equity or investment securities complies with TFC § 184.101	Select Response
Comments:	
<p>3g. Determine compliance with Section 183.109(a) and (b) of the Texas Finance Code regarding transactions involving management and affiliates. Review the terms of the transactions for potential preferential treatment or conflict of interest in accordance with the TAC §17.3.</p>	
Transactions in compliance with TFC § 183.109(a) ?	Select Response
Lease transactions in compliance with TFC § 183.109 (b) ?	Select Response
Compliance with TAC § 17.3 related to sale or lease agreements?	Select Response
Comments:	

4. Investment Strategy & Policy
<p>4a. Review the investment strategy and policy.</p> <ol style="list-style-type: none"> 1) Describe the trust company’s investment strategy. 2) Note any deficiencies in the policy or exceptions that have not been approved by the Board or their designee. Refer to Appendix II for Investment Policy guidance.
Comments:
<p>4b. Determine the adequacy of Board/committee oversight of investment activities considering committee minutes if available and the adequacy of the reports submitted to the Board to include transactions, composition, maturity distributions, ratings, average yield, appreciation/depreciation, policy and strategy compliance.</p>

#8 ASSET QUALITY

Comments:

5 Portfolio Risks

5a. Evaluate the portfolio for embedded options, potentially higher risk instruments such as structured notes or CMO/REMIC, or thinly traded or below investment grade securities (credit risk). Complete the respective SAP for any of these investments identified in the evaluation. Summarize **conclusions** from the SAP.

Comments:

5b. Ensure that any securities transfers between AFS/HTM or any sales out of the HTM category have occurred in accordance with FASB ASC Topic 320-10-35 (formerly FAS 115).

See ASU 2017-12 Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities;

ASU 2019-10, Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates; and

OCC Bank Accounting Advisory Series (August 2022) for additional guidance.

Comments:

5c. Determine compliance with investment limits related to:

Corporate bonds or notes, Municipal revenue bonds, Privately issued mortgage-derivative securities not fully backed by government guaranteed loans, Other asset-backed securities, Residual interests, Mutual funds not invested completely in U.S. Government or Government-sponsored agency issues, Adjustable-rate preferred stock, and Money-market preferred stock.

Indicate compliance below. Comment on noncompliance. Refer to Texas Finance Code §§184.101 thru 184.105 and TAC §19.22 .

Complies with Investment limits for Securities per TFC §184.101

Select Response

Complies with TFC §184.102 transactions in state trust company shares or participation shares

Select Response

Complies with TFC §184.103 investments in state trust company subsidiaries

Select Response

#8 ASSET QUALITY

Complies with TFC § 184.104 other investment provisions	Select Response
Complies with TFC § 184.105 investments in trade or commerce prohibited	Select Response
Complies with and 7 TAC § 19.22 investments in mutual funds	Select Response
Comments:	
<p>5d. If the trust company has a direct equity investment in a bank service corporation, agricultural credit corporation, small business investment corporation, banker’s bank, or a housing corporation, evaluate compliance with investment limits specified in the Texas Finance Code §34.105. If the trust company has a direct equity investment in a type other than those listed above, this statute prohibits the investment in equity securities except as necessary to avoid or minimize a loss on a loan or investment previously made in good faith.</p>	
Complies with TFC § 34.105 related to other direct equity investments	Select Response
Comments:	
<p>5e. Determine if the trust company engages in swaps, financial futures, forward placements, options or standby contracts, dollar rolls, other nontraditional investment/hedging activities, or securities lending. Consider the following if the above activities are applicable to the trust company:</p> <ol style="list-style-type: none"> 1) Are recordkeeping systems adequate to indicate that stated policy guidelines are being followed? 2) Does the trust company maintain general ledger memorandum accounts which include the type, amount, maturity, market price, and cost of each contract? 3) Are these activities reasonably correlated to the trust company’s other activities and business needs? 4) Does management demonstrate adequate knowledge and expertise to sufficiently control the use of these activities? 5) Does the trust company engage in securities lending? If so, then evaluate compliance to the FDIC’s FIL 81-97. 	
Comments:	

6. Internal Controls

6. Ensure that no one individual has total control over the purchase, booking, and sales of investment

#8 ASSET QUALITY

securities. Compare safekeeping confirmations to trust company records. Comment on trust company practices and any significant deficiencies.

Comments:

8. Concentrations

8a. Comment on key concentrations of risk in the securities portfolio (i.e., securities by individual security/single issuer, by industry, geographic location, with similar characteristics and with credit enhancer.)

Comments:

8b. Provide a list of securities considered for classification to the EIC.

Refer to the Department's [SM 1007](#) and the FDIC Risk Management Manual of Examination Policies – [Section 3.3 Securities and Derivatives](#) for guidance.

Comments:

9. Final Analysis

9. Assess overall management of the investment function, and its potential impact on the overall condition of the trust company. Complete the [Summary of Findings](#).

SUMMARY OF FINDINGS

#8 - ASSET QUALITY

Describe all strengths evident from the evaluation.

Describe all weaknesses evident from evaluation, including violations of law/regulation/rules; noncompliance with Departmental policies/guidelines; internal policy deficiencies/noncompliance; internal control weaknesses; MIS problems; and deficiencies in management supervision.

Determine why weaknesses exist and comment on management's response and plan of action. Identify trust company personnel making the response.

SUMMARY RISK RATING ASSIGNED: **Select Rating**

Ratings: 1-Strong; 2-Satisfactory; 3-Less than satisfactory; 4-Deficient; 5-Critically deficient; NR-Not Rated



Ratings
Definitions.xlsm

Provide copy of this page to EIC/AEIC. Receipt and review of this form by the EIC/AEIC will be evidenced by his/her initials in the appropriate column for this procedure on the SCOPE FORM.

[Return to Core Analysis](#)

SUPPLEMENTAL ASSESSMENT PHASE

Document findings in the SAP. Summarize conclusions in the CORE ANALYSIS section.

Portfolio Risk SAP

Portfolio Risk – Evaluate the Portfolio (Q5a)

STRUCTURED NOTES

Refer to FDIC [FIL-59-2004](#) and [FIL-20-2009](#) for detailed guidance and FDIC Risk Management Manual of Examination Policies, [Section 3.3 Securities and Derivatives](#), the [FDIC Capital Markets Resource Center](#), and the [FRB Trading and Capital-Markets Activities Manual](#).

1. For Structured Notes purchased since the last examination:
 - a. Is there evidence that appropriate pre-purchase analysis was performed?
 - b. Is there evidence that management understood the risks inherent in the bonds prior to purchase?
 - c. How did the purchase fit into the trust company's investment strategy at the time?

2. Are any issues at, or approaching, nonaccrual due to index performance?

3. Are any issues subject to principal loss due an index amortizing or other feature?

Comments:

[Return to Core Analysis](#)

CMO/REMIC

Completion of supplemental section is not required for investments in Priority Bonds or Planned Amortization Classes (PACS), and TAC structures, which generally have less prepayment or volatility risk than Companion, Support and Shifting PAC bonds which have senior/subordinate prepayment structure.

For more information on CMO/REMIC, consult FDIC Risk Management Manual of Examination Policies, [Section 3.3 Securities and Derivatives](#), . the [FDIC Capital Markets Resource Center](#), and the [FRB Trading and Capital-Markets Activities Manual](#)

1. For CMO purchased since last exam, verify that:
 - a. there is evidence of appropriate pre-purchase analysis performed;
 - b. there is evidence that management understood the risks inherent in the bonds prior to purchase; and
 - c. the purchase fits into the trust company's investment strategy at the time.

2. Does the trust company have a monitoring and reporting system in place to evaluate the expected and

Portfolio Risk SAP

actual performance of any mortgage derivatives/mortgage-backed securities that appear to be of high volatility?

Comments:

[Return to Core Analysis](#)

BELOW INVESTMENT GRADE SECURITIES

1. If a security is rated, determine whether it is investment grade. See [Appendix III](#) for informational purposes only.
2. If it is below investment grade, consider classification under the Uniform Interagency Standards.
 - a. The nationally recognized statistical rating organizations (NRSROs) provide qualitative credit ratings which provide useful information for determining investment quality. However, those ratings are not infallible. Examiners will deviate from published ratings when the facts clearly support contrary findings. However, such deviation would require strong support when the NRSROs provide unanimous qualitative evaluations. As with any asset, actual credit soundness serves as the conclusive investment quality standard.
 - b. When two or more NRSROs list different credit ratings for the same instrument, examiners will generally base their assessments on the more recently issued rating.
3. Verify externally provided credit ratings for several securities. One ratings source is [Moody's](#).
4. If a security is not rated, determine if management performed sufficient financial analysis to support the credit quality.
 - a. Refer to [Section 3.3](#) of the [FDIC's Risk Management Manual](#) for discussion of factors to analyze when evaluating municipal securities. For municipal securities in Texas, a current Texas Municipal Report (TMR) may be available.
 - b. Non-rated corporate bonds and preferred stock should have a prospectus or financial statement to support the credit quality.
 - c. Non-rated mutual funds should have a current prospectus to support the credit quality.

Comments:

[Return to Core Analysis](#)

APPENDIX I

Goodwill and Intangibles

Goodwill is an unidentifiable intangible asset that is acquired in connection with a business combination accounted for as a purchase, including an acquisition of a trust company to which push down accounting applies. This intangible asset is recorded on the balance sheet when the cost of an acquisition exceeds the fair value of the identifiable tangible and intangible assets acquired less the fair value of the liabilities assumed.

Some trust companies remain unaware of the accounting changes for the treatment of goodwill and other intangible assets. This could be a sign of an incompetent or inadequate internal audit. Goodwill should not be amortized in most cases after January 1, 2002, but should be tested for impairment annually. Core deposit intangibles should be recognized separately from goodwill in most cases. If these assets are not recognized appropriately Capital levels could be skewed.

For additional guidance refer to:

- FASB *ASC Topic 805-Business Combinations* (formerly FAS 141). This Topic establishes principles and requirements for how the acquirer does each of the following:
 - Recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree
 - Recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase
 - Determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.
- FASB *ASC Topic 350-Goodwill and Other* (Formerly FAS 142). This Subtopic addresses financial accounting and reporting for intangible assets (other than goodwill) acquired individually or with a group of other assets. Addresses the accounting treatment of acquired intangibles including impairment testing.
- Call Report Instructions-Glossary, Business Combinations

[Return to Core Analysis](#)

APPENDIX II

Investment Strategy and Policies

The board is responsible for adopting comprehensive, written investment policies that clearly express the board's investment goals and risk tolerance. Policies should be tailored to the trust company's needs.

Consider the following in relation to the scope of investment activities:

1. Has the policy been reviewed / revised by the board of directors within the last year?
2. Does the policy address the following as appropriate:
 - d. Investment objectives
 - e. Types of permissible investments
 - f. Risk diversification guidelines
 - g. Maturity parameters
 - h. Minimum quality ratings
 - i. Documentation requirements
 - j. Valuation procedures and frequency
 - k. Guidelines for pledging securities
 - l. Guidelines for other money market instruments such as time deposits, federal funds sold, commercial paper, securities purchased under agreements to resale, etc.
 - m. Hedging, swaps, caps, repos, or other nontraditional investment activities, or the prohibition thereof, if applicable
 - n. Accounting guidelines for securities
 - o. Periodic review of the securities portfolio to determine that investment objectives and ASC Topic 320 Investments—Debt and Equity Securities (formerly FASB 115) strategies remain appropriate, and objectives are being achieved
 - p. Trading limits and guidelines, if applicable
 - q. Personnel authorized to initiate transactions
 - r. Investment authority limitations
 - s. Guidelines for selecting and monitoring securities firms and salespersons to be utilized
 - t. Analytical data to be provided to the board/investment committee
 - u. Conflict of interest guidelines for employees who are directly involved in purchasing and selling securities, to the extent they also engage in personal securities transactions with these same securities firms
 - v. Guidelines regarding the receipt of gifts, gratuity, or travel expenses by directors, officers, and employees from approved securities dealer firms and their employees.

[Return to Core Analysis](#)

APPENDIX III

Investment Grades – For Information only

Credit Ratings Utilized by Outside Rating Services

Investment Quality

Moody's	Standard & Poors
Aaa	AAA
Aa	AA
A	A
Baa	BBB
Ba	BB
B	B

Sub Investment Quality

Moody's	Standard & Poors
Caa	CCC
Ca	CC
C	C
	D

[Return to SAP](#)