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Handbook: Trust and Asset Management

Subject: Introduction to Pre-Need Funeral and Cemetery Trusts

Section: 150

Pre-Need Funeral and Cemetery Trusts

Summary: This Regulatory Bulletin transmits new Section 150, Introduction to Pre-Need Funeral and Cemetery Trusts. It contains guidance and procedures for examining pre-need funeral and cemetery trusts.

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SUMMARY OF CHANGES

OTS is issuing a new Trust and Asset Management Handbook Section. Section 150, Introduction to Pre-Need Funeral and Cemetery Trusts, provides examiners with a program to examine an institution's administration of pre-need funeral and cemetery trusts.

BACKGROUND

Pre-Need Funeral Trusts and Cemetery Trusts – The fundamental purpose of pre-need funeral and cemetery trusts is to allow consumers to arrange and pay in advance for family funeral services (pre-need funeral trust) or cemetery merchandise (cemetery trusts). These arrangements involve three parties, the consumer who wishes to arrange for services for a family member (beneficiary), the funeral home or cemetery company (funeral home), and the savings association or other trustee who administers the funds pre-paid by the consumer until such time as they are either paid to the funeral home (in case of death) or returned to the consumer (in case of cancellation of the contract with the funeral home). It is the funeral home with which the savings association has a primary business relationship. The savings association rarely has any contact with the ultimate consumer but rather remits the proceeds of the trust to the funeral home in accordance with the governing trust agreement.

A handwritten signature in black ink that reads "Thomas A. Barnes".

— Thomas A. Barnes
Deputy Director

Examinations, Supervision, and Consumer Protection

Introduction to Pre-Need Funeral and Cemetery Trusts

This section addresses the administration of pre-need funeral and cemetery trusts. Policies and procedures should be evaluated in light of the size and character of the pre-need funeral and cemetery business and the mandates of the contracts governing the relationships.

The fundamental purpose of pre-need funeral and cemetery trusts is to allow consumers to arrange and pay in advance for family funeral services (pre-need funeral trust) or cemetery merchandise (cemetery trusts). These arrangements involve three parties, the consumer who wishes to arrange for services for a family member (beneficiary), the funeral home or cemetery company (funeral home), and the savings association or other trustee who administers the funds pre-paid by the consumer until such time as they are either paid to the funeral home (in the case of death) or returned to the consumer (in case of cancellation of the contract with the funeral home). It is the funeral home with which the savings association has a primary business relationship. The savings association rarely has any contact with the ultimate consumer but rather remits the proceeds of the trust to the funeral home (grantor) in accordance with the governing trust agreement (sometimes referred to as the Master Trust Agreement).

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This is unlike a traditional trust where the trustee would provide funds directly to the beneficiary.

State law dictates the percentage of the funds which are provided to the funeral home and the percent that must be held in trust. State law governing pre-need funeral trusts vary considerably from state to state. Contracts between consumers and funeral homes also vary from funeral home to funeral home as do the trust agreements administered by the savings association or other trustee.

Pre-Need Funeral Trusts

Pre-need funeral trusts are typically governed by two separate but inter-related contracts. The first is a contract between the consumer and the funeral home which outlines the terms of the funeral or cemetery arrangement that will be provided upon the future death of the family member and the prepayment terms (lump sum, installment payment, etc.) required for these future services. These arrangements are governed by state law which varies from state to state. Most state statutes require the funeral home to deposit the prepaid funds into a trust account.

The second contract is between the funeral home and the savings association or other party serving as the trustee. This Master Trust Agreement outlines the conditions under which the trustee will release the funds to the funeral home (once services have been provided), to the consumer (should the consumer cancel the contract), or to the consumer's estate (if there are excess funds after burial

expenses have been paid). The Master Trust Agreement also establishes how the funds will be managed or invested by the trustee. Again, the terms of the Master Trust Agreement are usually dictated by state statute.

Cemetery Trusts

There are two types of cemetery trusts – the “endowment care” cemetery trust and the “service and merchandise trust.” Endowment care cemetery trusts are created to provide for the continued maintenance of gravesites and common areas of the cemetery. Service or merchandise trusts are established by the funeral home to provide a means for consumers to prepurchase such items as grave markers or headstones, burial vaults, and other amenities.

Endowment care trusts are generally required by state statute to be maintained in a separate trust for the care and maintenance of the cemetery property. These trusts are typically held in the name of the cemetery company. The terms of such trusts generally permit the cemetery company to withdraw funds on a regular basis to provide ongoing maintenance of the facilities while leaving the principal intact. State law usually restricts the placement and management of these trust funds to an institution with a physical presence in the state where the cemetery is located.

Service or merchandise trusts are usually of small dollar value (four to five thousand dollars) and are typically held in the name of the individual consumer purchasing the merchandise.

Account Administration

Once the trust is established, the trustee may not release funds to the funeral home without proof that the funeral services and merchandise were provided to the consumer. The funeral home may not otherwise access the funds in the trust account. Funds may be released to the consumer on cancellation of the contract under the terms of the contract. Controls should be in place at the savings association to ensure conformance with the fund release requirement as outlined in the Master Trust Agreement.

The funds deposited into the trust must be managed as separate trusts for each account opened unless state law permits the commingling of funds. If commingling is permitted, a master or omnibus account will be established with the trustee’s recordkeeping system indicating the individual account allocations.

Statements must be provided to the consumer in accordance with state law. Requirements relating to the detail, timing, and composition of the statement will vary from state to state. The Master Trust Agreement will specify the investment authority and the power of the trustee, which is dictated by state law. In many cases investments are limited to insured interest-bearing deposits or U.S. Government bonds. Wider investment pursuant to the Prudent Investor Rule (PIR) may be permitted in some states.

Pre-need funeral trusts are often irrevocable but may also be revocable depending on applicable state law. The Master Trust Agreement and the contract between the consumer and the funeral home will establish the revocability of the account and may provide the consumer with a choice of options if permitted by state law.

Tax Considerations

Tax laws in this area are complex and are outlined in Section 685 of the Internal Revenue Code for Qualified Funeral Trusts (QFT). The funeral home (as grantor of the trust) is considered the income and principal beneficiary; however income is generally taxable to the consumer as the purchaser of the contract.

Due Diligence

It is incumbent on the savings association to conduct a thorough review on the funeral home before entering into a business arrangement. Annual reviews should also be performed. Such reviews are imperative since any malfeasance or misfeasance on the part of the funeral home and associated media attention can negatively impact the savings association's reputation as well. State regulators are charged with examination and audit of funeral homes and cemeteries within their jurisdictions. Funeral homes and cemeteries, depending on size and organizational structure may also engage external auditors to provide for audit coverage. Access to these reports may be helpful to the savings association in conducting their reviews.

The savings association should also be fully familiar with federal and state laws regarding pre-need funeral and cemetery trusts including tax requirements as well as general state trust requirements. Mechanisms should be in place to ensure that the savings association remains knowledgeable of any changes in these laws and regulations.

Risk Considerations for Savings Associations

Savings associations may serve in a number of capacities in the pre-need funeral trust business. They may serve as trustee, custodian, investment manager, or a combination of these functions. Responsibilities (and inherent risk) in serving in these capacities for pre-need funeral or cemetery trusts are similar to those found in other fiduciary relationships.

- Reputation risk: The risk of the savings association being tarnished by the improper acts of a funeral home.
- Financial risk: The risk that the savings association cannot manage the business line profitably.
- Legal risk: The risk that legal action against the savings association may be initiated for taking inappropriate action or failing to follow contract or governing instrument requirements.
- Regulatory risk: The risk that the savings association fails to follow appropriate state law.

In particular the savings association may have responsibility for: safekeeping of assets, recordkeeping, investment discretion, tax reporting, income and distribution processing, and proxy voting. Risks inherent in the investment of account funds include:

- Credit risk: Risk that an investment obligor fails to meet the terms of any contract.
- Price risk: Risk that changes in value of an asset devalues the fiduciary account.
- Liquidity risk: Failure to achieve account objectives due to inability to sell assets or unexpected decrease in asset value.
- Interest rate risk: Risk to the fiduciary account stemming from rapid or unexpected movement in interest rates.

Management of a pre-need funeral and cemetery trust business line requires the same board and management oversight, risk management, compliance, and audit supervision as any other fiduciary activity. The savings association should engage the following controls:

- Strategic and business planning addressing this business line.
- Policies, procedures, and training outlining the requirements and parameters for this business line.
- IT systems, internal controls, and monitoring systems robust enough to properly control this business line within the framework established in policies and approved parameters.
- Proper reporting channels including incorporation into appropriate committee agendas.
- Audit and compliance personnel including this business line in their planning and testing regimen.

EXAMINATION CONSIDERATIONS

Pre-need and cemetery trust administration should be incorporated into examination scoping, PERK, and procedures. The extent of examination resources employed should be driven by the volume of pre-need and cemetery business, its relative importance to the savings association, any material changes in the volume or complexity of the Master Trust Agreement (i.e. number of funeral home clients) and volume of underlying client accounts. The extent, nature, and reliability of the savings association's risk management and underlying control environment should also be a factor. Section 150 procedures provide a framework for conducting an examination of these activities.

Pre-Need Cemetery and Trust Accounts Program

EXAMINATION OBJECTIVES

To determine the adequacy and effectiveness of the trust department's administration of pre-need funeral and cemetery accounts. Consider whether:

- Effective policies, procedures and internal controls have been established;
- Management and staff are knowledgeable;
- Actions and decisions are documented and supported; and
- Deficiencies are identified and promptly corrected.

EXAMINATION PROCEDURES

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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; determine if the trust department's practices conform to written guidelines; establish whether any significant changes in personnel, operations or business practices have occurred; and determine whether new products or services have been introduced. If items of concern are uncovered during Level I procedures 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 administration of pre-need funeral and cemetery trust accounts. Scoping material should include:
 - Savings association's risk profile.
 - Relevant PERK documents.
 - Previous trust and asset management examination report.
 - Work papers from the previous examination.
 - Board of director and other applicable committee minutes.
 - Complaint and litigation files.

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2. Review Board and committee minutes to determine that decisions and actions are appropriately documented.

3. Review policies and procedures related to the administration of pre-need funeral and cemetery accounts, noting any changes since the last examination. Determine the adequacy of policies and procedures, given the number and size of accounts, including:
 - acceptance of accounts.
 - administration of accounts.
 - termination of accounts.

4. Determine the nature and extent of compliance and audit department review or oversight over the pre-need funeral and cemetery trust business of the savings association. Determine if compliance and audit reviews are effective. Review applicable compliance and audit reports. Note any material deficiencies and corrective actions.

5. Interview management to determine whether policies and procedures are followed in regards to:
 - Account approval.
 - Obtaining committee approvals.
 - Acquiring necessary documents.
 - Preparation of synoptic records.

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6. Review the initial process that the savings association undergoes before accepting a new business relationship with a funeral home or cemetery, determine if:
- There is input from the saving association's audit, legal or compliance department prior to acceptance of the relationship.
 - There is a review of the underlying Master Trust Agreement with the pre-need provider, including legal review.
 - The savings association conducts an analysis of the financial impact of beginning a new business relationship with a funeral home or cemetery.
 - Any determinations are made as to the profitability of new pre-need funeral and cemetery accounts prior to their acceptance.
-

7. Determine whether management has:
- Implemented effective policies and procedures to cover all facets of the pre-need funeral and cemetery trust administration.
 - Established comprehensive and effective audit, compliance and risk management processes.
 - Exhibited the appropriate level of expertise to ensure compliance with applicable law and accepted fiduciary principles.
 - Appropriate management reporting systems.
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8. Review the master list or account ledger(s) to determine account types and volumes being administered. Determine:
- Any changes in product offerings since the previous examination.
 - Whether required approvals, notifications or registrations have been filed.
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9. Review staffing.
 - Determine whether it is sufficient to carry out administrative functions in accordance with existing policies and procedures.
 - Determine whether there is an appropriate level of expertise.
 - Identify and note any changes in personnel responsible for the administration of pre-need funeral and cemetery trusts.
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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 a further analysis of documents such as policies, reports, agreements, and outsourcing contracts collected during Level I procedures. The examiner should complete the appropriate Level II procedures when the completion of 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.

10. Review the training provided to new and existing employees assigned to handle pre-need funeral and cemetery trusts. Determine if:
 - Initial training is provided to new employees.
 - Ongoing training is provided to employees, by either inside or outside sources.
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11. Review closed account policies and procedures to determine if:
 - There are established procedures for closing accounts and if reasons for closing are noted.

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- There are established procedures to ensure that assets are transferred to the appropriate party (consumer or funeral home/cemetery) in a timely manner.
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12. Determine whether any system is in place to monitor media attention, newsclips, etc. regarding funeral homes or cemeteries which the savings association maintains a business relationship for potential impact to the savings association's reputation risk.

13. Review a sample of Master Trust Agreements between the institution and a number of funeral or cemetery providers. Determine:

- If the agreements are standard form or customized.
 - The nature and extent of compliance/legal/audit review.
 - Whether they were formally approved or ratified by the appropriate authority.
-

14. Select a sample of pre-need and cemetery accounts for review. Determine if:

- There is timely and accurate filing of tax return information for accounts, where appropriate.
 - Receipts and disbursements are received and processed appropriately.
 - Appropriate documentation is maintained supporting all account transactions.
 - Initial, annual, and closing account reviews are adequately performed and documented in a timely manner consistent with internal policies and procedures and OTS regulations.
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If the examiner cannot rely on the trust and asset management Level I or Level II procedures, or data contained in department records or internal or external audit reports, proceed to Level III.

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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 the OTS examination staff to duplicate or substitute for the testing performed by auditors.

15. Review all accounts in which litigation is pending or has been threatened, and accounts for which complaints have been lodged with the institution.
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16. Review all accounts reviewed internally by compliance or audit which exhibit identifiable concerns.
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17. Review all accounts holding illiquid or unusual assets to determine consistency with the terms of the Master Trust Agreement and client contracts.
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18. Pull an extensive sample of accounts to determine compliance with terms of the Master Trust Agreement, applicable law, accepted fiduciary principles as well as conformance with policies and procedures. Ensure that the sample contains all types of accounts, including a selection of new, seasoned and closed accounts and provides coverage of all administrative personnel and all business locations.
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19. Review an extensive sample of customer account statements to determine accuracy.
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20. Review an extensive sample of closed accounts to determine if the accounts were closed in accordance with established procedures and the assets transferred in a timely manner.
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21. Review all accounts with discretionary account investments. Determine:

- Adherence to the terms of the master agreement
 - Meeting of account objectives.
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22. Review all accounts where the Master Trust Agreement contains restricted investment clauses to determine compliance with the terms of the agreement.

EXAMINER'S UITRS RATING, SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

REFERENCES - 150P

Laws

HOLA Section 5(n), Trusts

Code of Federal Regulations

12 CFR 550 Trust Powers (General)

12 CFR 550.200-220 Review of Fiduciary Accounts

12 CFR 550.410 Recordkeeping

Office of Thrift Supervision Publications

Other

Prudent Person Rule

Prudent Investor Rule

State Pre-Need Funeral and Cemetery Statutes

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WORK PAPER ATTACHMENTS - 150P

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.

Preacceptance Review

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| <ul style="list-style-type: none"> • Does the savings association conduct appropriate due-diligence and annual review of funeral homes and cemetery businesses with which it does business? |
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Account Approval

- | |
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| <ul style="list-style-type: none"> • Are savings association personnel knowledgeable regarding how to open, manage, and close funeral and cemetery trusts? |
| <ul style="list-style-type: none"> • Are participant records supported by pre-need or cemetery contracts and correctly entered into the participant recordkeeping system? |
| <ul style="list-style-type: none"> • Are new perpetual care trust funds supported by valid trust agreements? Are deposits accurately and timely posted to the trust accounting system? |
| <ul style="list-style-type: none"> • Are funds received from the client firm timely deposited to the trust fiduciary account? |

Earnings

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|---|
| <ul style="list-style-type: none"> • Does the savings association have a mechanism to evaluate and monitor the profitability of the pre-need and cemetery business line? |
| <ul style="list-style-type: none"> • Is income generated from trust investments reflected on the trust accounting system and payments collected when due? |
| <ul style="list-style-type: none"> • Is income recognized on the trust accounting system appropriately allocated to participant records? |
| <ul style="list-style-type: none"> • Is interest earned from own deposit accounts appropriately allocated to participant records? |
| <ul style="list-style-type: none"> • Is interest calculated and credited to participant records accurately and timely posted to the trust accounting system? |

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Compliance/Audit Coverage

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| • Does savings association legal staff or compliance staff monitor funeral and cemetery laws in the state or states in which they do business? |
| • Does the savings association provide audit coverage for funeral and cemetery accounts? |
| • Is appropriate training for savings association personnel conducted on an ongoing basis? |

Distributions

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| • Are distributions for death claims for pre-need contracts processed only on receipt of evidence that client firm has made delivery of goods and services as required by state regulations? |
| • Are distributions for cancelled contracts only made based on valid requests? |
| • Are distributions made to the correct client firm for the correct amount? |
| • Are distributions processed accurately and timely on the trust accounting system? |
| • Are distributions of income from perpetual care trusts accurately and timely recorded on the trust accounting system? |
| • Are distributions of income from perpetual care trusts made in accordance with the governing trust instrument and state perpetual care requirements? |

Accounting

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| • When the savings association serves as both trustee and recordkeeper are transactions processed and recorded on both the participant recordkeeping system and the trust accounting system? |
| • Does daily settlement of trust securities transactions occur timely between the savings association and the correct counterparty? |
| • Are only authorized trades conducted with approved mutual fund companies? |
| • Does settlement between trust accounting and deposits occur accurately and timely? |
| • Are market values of securities and mutual funds held periodically updated and properly reflected on the trust accounting system? |

Reporting

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| • Are monthly and quarterly reports accurately and timely prepared and sent to client firms? |
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Information Technology

• Is logical access to data files and computer applications limited to individuals with legitimate business need commensurate with their duties?
• Is the processing of production applications and data controlled by a documented scheduling process?
• Is system data backed up regularly and archived data available for restoration in the event of processing errors and/or disruptions?
• Is physical access to computer equipment and storage media restricted to individuals with a legitimate business need?
• Have procedures been developed to support the resumption of time sensitive business operations and functions in the event of their disruption?
• Are changes to existing systems and software authorized, prioritized, tested, and approved as part of their implementation process?

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