

To: Deputy Comptrollers, Assistant Deputy Comptrollers, Large Bank Examiners-in-Charge, and Asset Management Lead Experts

From: Emory W. Rushton, Senior Deputy Comptroller for Bank Supervision Policy
Leann Britton, Senior Deputy Comptroller for Bank Supervision Operations

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Subject: Preneed Funeral Trust Accounts

Purpose

This memorandum is being issued to accomplish the following:

- Provide an overview of the preneed funeral planning industry.
- Describe the risks associated with the type of services national banks are providing to this industry and discuss appropriate risk management processes.
- Advise examiners that they should review this activity during examinations of banks that provide these services and ensure that appropriate risk management processes are in place.

Background

National banks have served as trustees and custodians for preneed funeral trusts for many years. Nevertheless, the increasing size of this industry and growing demand for its products as well as many reports of problems with product performance and administration have created the need for a better understanding of the business and its risks to national banks.

Business description, product structure, and state regulation

“Preneed” funeral planning is a term coined by the funeral industry to describe the arrangement and payment of a funeral prior to death. The aggressive marketing of preneed plans for funeral services and merchandise is increasingly prevalent. The funeral industry provides preneed funeral plans primarily through the sale of insurance policies or the establishment of trust accounts. At the time of death, the insurance proceeds or the assets in the trust account pay the consumer’s funeral expenses. Generally, consumers can only purchase funeral contracts with prefunding mechanisms through state licensed funeral companies. The average size of a preneed funeral contract is approximately \$5,000 and the purchaser is usually elderly with limited financial resources.

Forty-nine states, Alabama being the exception, have enacted laws regulating the funeral business and sale of preneed funeral contracts. While the laws vary in form and substance, most states require funeral companies to place all funds received for payment of a preneed funeral contract into a trust account with a federally insured financial institution. Once in trust, the funeral company cannot access the funds until the death of the consumer. Only after the trustee receives proof that the funeral director delivered all services and merchandise are funds released. Where state law permits, the trustee may commingle funds

in a “master trust.”¹ Otherwise, the trustee must manage these as individual trust accounts subject to applicable state law.

State law typically requires that the purchaser of a preneed funeral contract receive a statement of funeral goods and services that summarizes the terms of the arrangement. The statement includes the amount the consumer agrees to prepay, the types and cost of services and merchandise purchased, the terms and conditions of the agreement, and where the funeral director will deposit the prepaid funeral funds. If a preneed trust arrangement is selected, the funeral company establishes a trust for the consumer following state preneed funeral contract requirements. The funeral home or director is the grantor of the trust and the income and principal beneficiary, although income is generally taxed by the IRS to the purchaser of the contract.

Many states require that a bank serve as the trustee, but some allow the funeral director or other parties to serve as trustee. The preneed funeral trustee may also serve as custodian and investment manager of the trust funds. The trust is established for the purpose of investing, protecting, and conserving funds received pursuant to the preneed funeral contract in prepayment of funeral services and merchandise. The state’s role is to audit the funeral home to see if it is funding trusts correctly, in amount and timing, and is not withdrawing funds inappropriately.

Preneed funeral trust accounts may be revocable or irrevocable depending upon state law and the contract terms. Usually the consumer has a choice. An irrevocable trust may be necessary to enable consumers to maintain their eligibility for state or federal income assistance. With a revocable trust, the funeral company or director must return all, or substantially all, income and principal to the purchaser upon proper revocation notice. Some states permit the funeral director to retain all or part of the income accrued through the date of revocation, and several states permit the director to retain part of the principal. Most state laws require the agreement to allow the consumer to select a different funeral provider anytime before the consumer’s funeral. The notice requirements depend upon state law and the contract/trust agreement terms.²

State law and the trust agreement determine the trustee’s investment authority and powers. Several states limit investments to interest-bearing deposit accounts in an insured, state domiciled financial institution, while others permit investment pursuant to the *Prudent Investor Rule*³ if the trustee is a financial institution with trust powers. Many states restrict investments to high quality, fixed income obligations such as certificates of deposit and U.S. Government bonds.

State law also determines whether a funeral company can collect all the proceeds from a funeral trust or only the amount needed to cover the actual cost of the goods and services delivered. Usually, if the funds available exceed the funds required, the trustee returns the excess to the estate of the deceased. Some

¹ For example, the California Funeral Directors Association (CFDA) has established and operates the California Master Trust which serves 279 funeral homes and approximately 30,000 consumers in California. CFDA website.

² Source material for most of this background was included in a limited purpose national bank’s charter application package dated November 8, 1996.

³ American Law Institute, Restatement (Third) of Trusts: Prudent Investor Rule. In general, the standard of investment prudence is applied to any investment as part of the total portfolio, rather than to individual investments. The tradeoff between risk and return is a central consideration and all categorical restrictions on types of investments are abrogated. Fiduciaries are required to diversify investments within the portfolio.

states allow the funeral company to retain the excess in guaranteed price contracts.

National banks that serve as trustees for preneed funeral trusts are subject to 12 CFR 9, Fiduciary Activities of National Banks, and other applicable trust law.

Industry Characteristics

Publicly reported numbers concerning the size of the preneed funeral business⁴ are not available. In addition, federal financial regulators do not collect specific information concerning the preneed funeral business. According to the American Association of Retired Persons, over 17 million people had purchased preneed funeral contracts by 1995. Various industry sources estimate there are between \$20 and \$25 billion in outstanding preneed funeral contracts and project a continuing trend of substantial growth as the population continues to age and better plan for death expenses.

Historically, most of the competition for the preneed funeral trust business has been among small financial institutions in a local marketplace.⁵ In recent years, however, the industry has begun to consolidate with larger financial institutions forging alliances or merging with regional and national funeral companies. The preneed funeral planning business is volume driven and economies of scale are important. Increasing product demand, technological improvements, and the ability to provide trust services nationally are creating potentially profitable opportunities for larger financial institutions and may be driving the industry alliances and consolidation trends.

The rapid growth and profitability of the business combined with purchaser characteristics have created opportunity for fraud and customer abuse. Several consumer groups and studies, including a recent report by Money Magazine⁶, have called preneed funeral plans one of the top abuses of the elderly. Money reported that customers have “lost big bucks” in California, Illinois, Iowa, and Pennsylvania in recent years. Some sellers of prepaid plans use high-pressure sales tactics or simply vanish with the consumer’s payment. Taking advantage of consumers and committing fraud and theft in this industry tends to be somewhat easy because of the time lag between a contract’s purchase and actual death of the consumer, lapses in regulatory oversight, and consumers’ general lack of sophistication and understanding of the contract.

Recently, regulators have identified a number of problems involving the preneed funeral business. The State of Florida initiated disciplinary action against 16 commonly owned funeral homes alleging that the homes amended signed contracts without consumer approval, made improper or unsupported withdrawals from trust funds, used unregistered agents to sell preneed contracts, failed to disclose pricing in advance, and were as much as a year late in filing regulatory reports.

In another case, Federal and state authorities are investigating problems associated with a national bank’s administration of its preneed funeral trust relationships. Issues include poor due diligence of service

⁴ The National Funeral Directors Association (NFDA) maintains general statistics relating to mortality rates and burial costs in the United States, but does not collect data specifically relating to the volume of preneed funeral contracts. An NFDA spokesperson indicated there is no centralized database that collects this information, but the data may be collected by each state.

⁵ Hillenbrand Industries, Inc. 1997 Annual Report.

⁶ *Money Magazine*, The Final Payment. The Funeral Industry is Greedier Than Ever. Here=s How to Avoid a Gouging On..., September 1997.

providers, deficient trust administration, and possible violations of Federal and state law. These problems have resulted in substantial losses to the bank and its customers.

Risk Issues for National Bank Supervision

National banks serve as trustee, custodian and investment manager for preneed funeral trusts. Generally, the risks from serving in these capacities for a preneed arrangement are not significantly different from risks created by other fiduciary relationships. The preneed trust may require a fiduciary to:

- comply with applicable state and federal law, including reporting requirements;
- safekeep all funds received, including income;
- manage, administer, and invest the assets as permitted by applicable law;
- exercise all voting and other rights relating to the trust funds;
- make payments from the trust according to the trust agreement and applicable law;
- maintain financial statements and other records with respect to the trust; and
- issue annual 1099 forms to the trust beneficiaries.

Nevertheless, preneed funeral trusts create certain risks for a national bank trustee to consider and manage. A fundamental difference exists between a preneed funeral trust and other trust relationships. Many banks serving as trustee in a preneed trust have only limited contact with the purchaser of the funeral contract and provider of the trust funds. The bank's contact and business relationship is primarily with the funeral company. The consumer's primary contract is with the funeral company or funeral director. Upon the death of the consumer, the bank remits the proceeds of the trust to the funeral company in accordance with the terms of the trust and contract, not to the individual's family or heirs as is common in most trust relationships.

What makes this complicated and sensitive is that preneed funeral trusts are usually accounts established by funeral homes on behalf of individuals who are elderly or have limited financial resources. In addition, trustees manage these funds for a particularly sensitive and emotional event. Absent appropriate policies, procedures, controls and monitoring systems, this business line can create increased transaction, compliance and reputation risks.

Poor management of preneed funeral trusts, including weak internal controls over account acceptance and disbursements, noncompliance with trust agreements and applicable law, and inadequate due diligence on funeral homes and directors, can negatively affect a bank's reputation. Banks that align themselves, or are affiliated, with funeral companies that have or subsequently develop reputation problems may themselves be tarnished, even if their internal practices are appropriate.

Preneed funeral trusts require the same level of supervisory oversight and risk management systems as other fiduciary activities in national banks. We expect banks that are active in this line of business to have appropriate strategic plans, policies and procedures, internal controls, MIS, and monitoring systems for this product. The administration of these accounts must comply with 12 CFR 9, Fiduciary Activities of National Banks, particularly the pre-acceptance, post-acceptance and annual review processes. It may be appropriate to have policies and procedures specific to this business line, and, if the business is significant for a bank, a separate administrative and investment review committee should be established.

It is imperative that national banks perform due diligence reviews on a funeral company before they enter

a business arrangement with it. Bankers should also perform annual reviews of companies with which a bank has established a business relationship. Bankers should administer the use of third party service providers, such as investment advisors or managers, with appropriate controls and monitoring systems. National banks should also include preneed funeral trusts in internal compliance and audit programs.

OCC Supervisory Response

The highest risk exposure in the national banking system may reside in trust companies whose primary business is preneed funeral arrangements and in banks that have recently become aggressive in soliciting this business. Examiners should review a bank's risk management practices relating to preneed funeral trusts during regularly scheduled supervisory activities. As with any other fiduciary activity, we expect each bank to effectively assess and manage the risks associated with providing preneed funeral trust services.

Questions relating to this issuance can be submitted to Grant Wilson at the Asset Management Division in Washington, (703) 874-4184 or grant.wilson@occ.treas.com.