



PRIVATE TRUST GROUP OF AMERICA

Community Banks Have Lost the Battle for Trust Services

The inability to offer trust services that provide even a modest financial return to the institution has finally caught up with community banks and local trust companies.

Locked in the historically insular world that relied on the obedient loyalty of their local communities, community banks and local trust companies were content to soft-sell their trust services as a loss-leader to their more profitable business lines. With a mindset that took their customer base for granted, and with no financial incentive to invest in a division that was a perennial loss-leader, these institutions have allowed more aggressive wealth management organizations to usurp their traditional hold on the trust services market.

Everyone saw it coming – except the bankers. Many are now scrambling to reinvent their trust departments by calling them “wealth management” divisions, with the expectation that they can add higher margin products and services such as insurance and brokerage to boost revenue and offset losses from trust services. The operative phrase here is “...offset losses from trust services.” Adding other more profitable products and services will only mask the underlying problems and guarantee that the losses will continue.

The practice of offsetting losses in one area with profits from another does nothing more than provide a false sense of coming up with a short-term solution for a long-term problem. It gives no incentive to managers of the area that is losing money to make the tough decisions necessary to turn things around, and it is a disincentive to managers of the profitable area if they see their hard efforts to turn a profit being used to prop up other less successful areas or departments. Without strict accountability based on strong fiscal policies, the practice will eventually lead to a vicious cycle of mediocrity resulting in the profitable area being unable to generate sufficient profits to subsidize the unprofitable one.

This article examines some of the underlying reasons that community banks and local trust companies have lost the battle for trust services, and offers some suggestions to prepare for winning the bigger war of who retains control of the local consumer in the broader wealth management services market. In our view the larger war is still winnable, but the battle was essentially lost because of management's failure to fully recognize the changing landscape created by the following events:

- 1.) The Uniform Prudent Investor Act
- 2.) Technology
- 3.) Increased Government Regulations
- 4.) The Commoditization of the Trust Services

The Uniform Prudent Investor Act

Historically, grantors and trust beneficiaries have looked to their community banks and local trust companies as the preferred choice to provide institutional stability and impartiality in carrying out the terms of their trust documents. Institutional stability provided the advantage of having a trustee that could serve multiple generations, but the institutional trustee also served as the "protector" of the family's wealth by "preserving" it in a manner consistent with what was known as "The Prudent Man Rule."

The Prudent Man Rule gave legal cover to trustees by emphasizing the need to avoid "speculating" on new or untried investments, which essentially limited investment choices to highly rated bonds or large cap, blue-chip American companies that were the mainstay of trust department investments until the Uniform Prudent Investor Act ("UPIA") was enacted in 1994. Although the UPIA retained the prudence standard by directing a trustee to invest "as a prudent investor would..." it also created a greater responsibility for trustees to diversify investments across a broad class of assets in order to mitigate risk.

Another important change brought about by the UPIA was to help clarify the non-delegation rule by specifically allowing trustees to delegate investment

management responsibility if a prudent person might delegate those responsibilities to others. In fact, the UPIA makes it clear that a trustee may sometimes actually have a duty to delegate investment functions by empowering the trustee to "...delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances." (See UPIA § 9(a).)

The UPIA was enacted at a time when the financial markets were in the midst of their remarkable run of consistent double digit returns in the mid-1990's, which created a greater awareness of investment performance by trust beneficiaries and increased demands on trustees to broaden their investment choices beyond the traditional trust department menu of AAA bonds and large cap, blue-chip American companies. The combination of these two events essentially turned the trust business on its proverbial head by shifting the focus of trust grantors and beneficiaries away from the local community bank to national and international investment managers.

Technology

In many ways, technology has outpaced the trust profession's ability to change. Open architecture has enabled larger wealth management organizations to exchange data and information across a broad spectrum of custodians and other service providers, thus creating a virtual supermarket of financial products and services for their clients. That same technology is available to community bank trust departments, but it will rarely be used because of the internal struggle to justify upgrading technology for a division that cannot turn a profit.

Reluctance on the part of existing personnel to change often contributes to the technology deficiencies experienced by many community bank trust departments. Learning a new software application or an entire operating system can be challenging for someone that has been with the bank for a long time and is just trying to get by until retirement. The reluctance to change is deeply embedded in the culture of many bank trust departments because of the bank's inability or unwillingness to commit the financial resources to a non-

profitable division – and to hold their employees accountable.

Even when trust personnel embrace the idea of adding new software applications or upgrading their trust accounting systems, they often do not have the time to push the new applications or systems to their limits because of myriad other responsibilities. Most community bank trust departments can ill afford the dedicated staffing required to operate, maintain and demand their software vendors to create more efficient methods to process trust accounting activities. As a result, technology has become the Achilles Heel of most community bank trust departments – they have just enough to get by, but not enough to become truly efficient.

Increased Government Regulations

It is no secret that the financial services industry has always been the most regulated in all of business, and has become even more so since September 11, 2001. This is particularly true of bank trust departments where the financial burden of a trust charter's capital requirements can reach several million dollars, and managing ongoing regulatory compliance issues can easily top six figures, annually. The financial burden of regulatory compliance alone creates a very significant hurdle for banks to overcome, and is a major reason that many bank trust departments are unprofitable.

With no end in sight, banking regulations will continue to put a strain on the financial resources of community bank trust departments, making it even more critical that bank executives find other ways to add revenue and reduce expenses. Meanwhile, law firms and other non-bank trustees and wealth management providers continue to increase market share without such costly and burdensome regulations.

The Commoditization of Trust Services

Some very large fund companies, broker/dealers and other high volume, national providers of wealth management services have already entered the trust business (Charles Schwab, Franklin Templeton and Fidelity are three that

immediately come to mind), and others are making plans to follow. No one is under the illusion that these organizations are entering the trust business because of its profit potential. They clearly see a way to entice more assets away from banks and other traditional trustees by offering custody services and an open architecture environment that allows grantors and beneficiaries to select from a broad range of high quality investment managers using their trading platforms.

With trust services now being driven almost entirely by investment performance, trustee selection has become a secondary decision for a new generation of grantors and beneficiaries. Investment expertise and performance now determine where the assets are managed, so it is imperative that trustees offer an open architecture environment that allows the grantor or beneficiary the ability to select from a large number of different investment managers. Failure for community banks, local trust companies and similar local providers of trust services to adapt to an open architecture environment will eventually cripple their ability to serve existing clients or attract new ones.

In the past, grantors and beneficiaries looked to their local community bank or trust company for the safety and security of an institutional trustee who could also provide investment advice. Because of the recent emphasis on investment performance, many of them now view the selection of a trustee as subordinate to that of an investment manager. Consequently, bank trustees have lost their ability to manage these key relationships and have relinquished the all-important “gatekeeper” status to the investment manager.

Certainly, grantors have historically favored naming a local institution as trustee or executor, but it is unrealistic to expect a new generation of grantors and beneficiaries accustomed to the advantages of having instant access to world-class financial products, services and information to simply accept the status quo and limited offerings of local trustees.

One can argue the merits of having a large investment management organization also serve as one’s trustee, but the arguments are no different than those that claim a small financial institution such as a community bank or local

trust company cannot effectively manage trust assets in today's global economy. Investment management now carries the day, which has rendered traditional trust services little more than a ministerial function that can be carried out by virtually anyone – from a client's local attorney or accountant to a major mutual fund company or brokerage house.

Community Banks May Have Lost the Battle, but Can Still Win the War

There are still strong indications that most people prefer to have local representation when it comes to discussing their personal, business, estate planning and other financial affairs. Local representation does not necessarily mean, however, that clients expect their trusts and financial assets to be **managed** locally. In fact, it may be a breach of fiduciary duty to actually manage certain assets or portfolios locally if greater returns with similar or more favorable risk factors can be achieved thru any number of other options that fall beyond the expertise of the local trustee.

In order for banks with less than upwards of \$1 billion in assets under management to win this war, they must focus their attention on regaining their historical role as “gatekeeper” of their clients’ overall financial affairs and not necessarily the local “manager” of their clients’ financial assets. Bank trust officers too often overemphasize the need to make investment decisions at the local level. Do clients expect to walk into a local branch and sit down with someone knowledgeable about investments? Absolutely, they do. Do they expect their local branch trust officer to make every decision about each individual investment in his/her portfolio? Occasionally, but it is increasingly rare.

With a trustee's ability to delegate investment responsibility, and with grantors' and beneficiaries' increased emphasis on investment performance, there is little reason for community banks and local trust companies to assume the inherent risks that come with making individual investment decisions for their clients – especially with so many high quality investment managers on the national and international scenes that are available thru various third party alliances at a reasonable cost.

It is not necessary to make a wholesale change to outside managers, but with today's open architecture technology that can deliver low-risk, high performing managers that are unavailable to the general public, internal investment management should be the exception rather than the rule.

Is a Centralized Administrative Trustee in Our Future?

Spiraling costs, increased government regulation and continued advances in technology are pushing bank trustees with less than \$1 billion in assets under management to a commoditized trust administration and operations solution that provides those services thru an "Administrative Institutional Trustee" at a centralized or regional location. Under this approach, the community bank will remain in control of each local bank relationship by assigning a local trust officer to become the "gatekeeper" for its clients' financial needs, but most investment decisions and all administrative and operational functions will be provided by the centralized Administrative Institutional Trustee.

Instead of placing unrealistic expectations on the bank and its trust/investment officers, this new approach will provide community banks and local trust companies with the opportunity to offer clients world-class and highly competitive trust services, including open architecture investment management options, without the high costs of maintaining the infrastructure. It is just the approach that is needed to turn the perennial loss-leader into a reasonable profit center, while boosting the bank's credibility to those seeking world-class investments and state-of-the-art trust services.

We can pretend that we are exempt from the challenges mentioned in this article and continue to accept mediocre results, or we can carefully examine and debate new ways to change a system that clearly is in need of improvement.

As the banner of our newsletter "[Sharing Ideas ~ Building Relationships](#)" reads, "Change is the incubator for success. We can embrace change and be energized by the opportunity, or we can shy away from it and become

paralyzed by inaction.” It is not a slogan; it is the foundation of our business. On behalf of its clients, Private Trust Group of America proudly accepts these challenges as an opportunity to improve an old system in need of new ideas.

If you would like to share your ideas, or would like more information about how to immediately take advantage of some of the principles mentioned in this article, we would like to hear from you.

About Private Trust Group of America

Private Trust Group of America is an employee-owned company specializing in providing administrative and operational support to trust departments and wealth management offices nation wide. With an executive staff that has over 100 years of combined trust and related technology experience, and a professional staff whose average experience exceeds 22 years, Private Trust Group of America offers an unusually high degree of frontline sophistication to its client base.

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