



PRIVATE TRUST GROUP OF AMERICA

Economic Downturn Provides Opportunities for Bank Trust Departments

"The United States has already slipped into a deep recession that could be the most serious since World War II. It could well be longer and deeper than the recession in the early 1980s that lasted 16 months."

Martin Feldstein, president of the National Bureau of Economic Research and a professor of economics at Harvard University, at a speech delivered March 15, 2008 in Boca Raton, Florida.

According to former Federal Reserve Chairman, Alan Greenspan, the U.S. has slipped into an "awfully pale recession" and may continue to languish for the rest of the year. Greenspan said that continued stagnation for the rest of this year may be the best the U.S. can hope for and might even be the most likely outcome. "That's certainly the most benevolent scenario," he said. "It's not all that far from being the most probable." – *Bloomberg Market Pulse, 5/5/08.*

With oil prices over \$120 a barrel, gasoline hovering just under \$4 a gallon, inflation in danger of surging to pre-Cold War levels and the mortgage/housing market in crisis, it's no wonder these two venerable economists both used the "R" word. Whether the glass is half full (Greenspan) or half empty (Feldstein), it doesn't take an economist to tell that the economy is a little shaky and, although the numbers for the first quarter have not made it official yet, it sure feels like the beginning of a recession. The real question is how deep and how long.

Signs of a Banking Slowdown

Even if community banks and small trust companies are sheltered from the mortgage crisis, which most are, they are just as susceptible to the other problems affecting the U. S. economy. Lower real estate values, tighter lending policies, smaller spreads in interest rates, consumer belt-tightening and lower deposits are just a few. While the economy was contracting during the fourth quarter of 2007, quarterly net income for FDIC insured institutions declined to a 16-year low.

Here are a few other lowlights of the FDIC's Quarterly Banking Profile for the fourth quarter of 2007:

- Fourth quarter net income of \$5.8 billion was the lowest amount reported since the fourth quarter of 1991 and nearly 85% below the fourth quarter of 2006;
- The average return on assets was 0.18%, down from the 1.20% recorded a year earlier and the lowest since the fourth quarter of 1990;
- A record \$31.3 billion in provisions for loan losses was set aside for the fourth quarter of 2007, more than three times the \$9.9 billion set aside for the same period a year earlier;
- Trading losses totaled \$10.6 billion, marking the first time the industry has recorded a quarterly net trading loss. In the fourth quarter of 2006, the industry had trading revenue of \$4 billion;
- More than half of all institutions (51.2%) reported lower net income than the fourth quarter of 2006, and 57.1% reported lower ROAs.
- One out of every four institutions with assets greater than \$10 billion reported a net loss for the fourth quarter;
- Fewer than half of all insured institutions (49.2%) reported improved earnings in 2007, the first time in at least 23 years that a majority of insured institutions have not posted full-year earnings increases;
- The percentage of institutions that were unprofitable in 2007 (11.6%) was the highest since 1991;

Large institutions accounted for most of these negative statistics, but small community banks and trust companies will not be immune from the current economic downturn. The residual effects of significantly higher inflation and much lower property values will further depress spending and reduce savings.

Some Positive News for the Trust Business

One good piece of news from the FDIC report showed that both trust assets and income from trust activities rose in 2007:

- Total assets in trust accounts increased by \$2.6 trillion (13.4%) during the year;
- Assets in managed accounts increased by \$68.6 billion (1.6%);

- Assets in non-managed accounts rose by \$2.5 trillion (16.9%);
- Assets in custodial and safekeeping accounts increased by \$9.8 trillion (20.3%);
- Net income from trust activities totaled \$12.8 billion, an increase of \$2.8 billion (28.6%) over 2006.

Large institutions also dominated the positive news, with just five institutions accounting for 53% of the industry's net trust income in 2007.

These statistics confirm some clear and unmistakable trends that could prove very significant for trust companies and community banks with trust departments. One is the disproportionate increase of \$2.5 trillion in non-managed accounts (16.9%) versus a rather anemic increase of \$68.6 billion (1.6%) in managed accounts. Another is the large increase in custodial and safekeeping accounts of \$9.8 trillion (20.3%).

Growth in non-managed accounts supports the idea that clients are moving to banks for basic institutional trust services but want their assets managed elsewhere. Banks and trust companies that can provide clients with seamless custodial integration and automated data aggregation (shadow accounting) services will have a decided advantage by allowing their clients the flexibility and benefits of working with multiple investment managers. By utilizing an open architecture investment management platform, the trust department can better control the relationship by provide all trust accounting functions (including consolidated reporting) while allowing their clients to use existing custodians and multiple investment managers.

Providing custodial integration and data aggregation services also increases the ability of these institutions to gather more custodial and safekeeping assets but, perhaps more importantly, it significantly enhances their ability to form strategic alliances with other wealth management professionals that do not hold trust powers.

The FDIC report is helpful, but should not be taken at face value. Because of the dominance of large institutions, small community banks and trust companies

should extrapolate data carefully from the report if they want to make a fair comparison to their peers. The full report is available on the FDIC's website.

Review Your Trust Department's Business Model

Difficult economic times generally affect trust departments to a far lesser degree than other areas of the bank or trust company; especially with the financial markets behaving reasonably well, which helps maintain gross trust income levels and takes some of the focus off cutting expenses. However, whether we are slipping into an "awfully pale recession" (in Greenspan's words) or into one that is "the most serious since World War II" (in Feldstein's words), trust department executives have a golden opportunity to work for the common good of the organization by taking a fresh look at their business models and coming up with ways to reduce expenses.

One of the most meaningful and significant, yet least disruptive cost reduction measures available to trust departments is to eliminate or revamp their internal operations center. Most trust departments don't even need one. Those services are now much more efficiently and cost-effectively delivered through highly experienced third party service providers.

The following quick example shows how the economics play out in many small community bank trust departments:

Minimum initial cost of trust accounting system & training	<u>\$50,000</u>
Annual fees, including system support & maintenance	\$50,000
Annual salary and benefits for head of operations	65,000
Annual salary and benefits for assistant	50,000
Allocation of departmental expenses & overhead	<u>5,000</u>
Total Annual Operating Expenses	<u>\$170,000</u>
Total Start-up and First Year's Operating Costs	<u>\$220,000</u>
Assets needed to breakeven @ 75 bps	\$29.3 million

Add a couple of frontline trust officer's salaries and benefits to this example and the annual operating expenses could increase by another \$250,000, or more.

That's a total of nearly \$500,000 in overhead that will require assets under management in excess of \$65 million just to breakeven (at a very generous average gross revenue rate of 75 bps).

What makes the above example even more costly than it appears is the fact that those start-up costs and annual operating expenses are usually incurred before business even comes in the door. Depending on the bank and the demographics of its customer base, it could take a couple of years to gather the \$30 million to offset just the costs of the operations center alone, and another two or three years to offset the costs of the frontline trust officers. That's a total of 4 to 5 years before the bank can even think of breaking even – and guess what happens next? As the bank approaches the breakeven point in terms of assets under management to support the costs of the entire trust department, additional staff is needed to handle the extra volume.

Contrast the start-up and annual operating costs in the above example with an outsourcing solution. The savings in upfront costs may not be significant, but the ongoing savings in annual operating costs are not only significant in real terms, but they are not incurred until the business actually comes in the door. Using the above example, a typical outsourcing solution would produce total savings of approximately \$500,000 over a 5-year period – even assuming no adjustments for additional staff or increases in salaries and benefits for the in-house operations center. *(For a more detailed review of the analysis or to find out more about the methodology, please contact Sandi Lotito or Ray Brearey at 978-463-9099.)*

An independent, critical look at the true profitability of the vast majority of trust departments will show that they are significantly underperforming other areas of the bank. Most, in fact, do not make a profit at all. The quickest and easiest way to correct that is to get out of the operations business and reinvest those savings into more frontline trust officer and new business positions.

Unfortunately, such actions require a change in the way trust departments have traditionally operated, and change can be disruptive – if we allow it. On the

other hand, change can be invigorating – if we embrace it. Either way, change is necessary for any business to achieve long-term success; and any effort to bring about positive change should be encouraged.

Creating an Atmosphere Conducive to Change

“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.” That phrase holds a revered position under the title of PTG’s newsletter *“Sharing Ideas ~ Building Relationships,”* and is at the forefront of our corporate culture. We are constantly exploring ways to improve by making changes as appropriate. For PTG, change is the fuel that energizes individual creativity and helps define who we are as an organization.

Change does not come easy for some. It requires moving out of one’s comfort zone by challenging the status quo. It removes us from the safety net of familiar choices and places us in the uncomfortable position of learning a new way to think or perform tasks. It can raise the specter of failure caused by the fear of attempting to change something that has been ingrained in the insular culture of a stagnant work environment. Worst of all, failure to embrace change is often the result of failed leadership that fosters complacency and breeds a lack of accountability that permeates the organization.

Change can also be hindered by an organizational culture of perfection based on the belief that any failure is unacceptable. Some of mankind’s greatest inventions and most important scientific breakthroughs have occurred as the result of repeated trials and errors (failures), many of which became the subsequent building blocks that changed the course of history. In fact, history is replete with examples of people who took chances and failed – only to come back again and succeed. As Henry Ford put it, *“Failure is the only opportunity to begin again more intelligently.”*

Sustained success resulting from change without failure is unattainable; failing to succeed out of fear of change is unacceptable. Every organization must

develop a culture of empowerment that encourages people to take chances without fear of failure. Without change, there can be no real measure of success or failure – and the organization will drift in a sea of mediocrity.

At PTG, we take a team approach to everything we do. Everyone in the organization is encouraged to strive for perfection – knowing that it is not attainable, but that it is a goal worthy of the trust placed in us by our clients. In doing so we expect a high rate of sustained success, but acknowledge that we must also accept some failures along the way. We recognize that individual accountability is essential in measuring the collective effort being made, but it's the overall team effort that determines the ultimate success of our organization.

"I have missed more than 9,000 shots in my career. I have lost almost 300 games. On 26 occasions I have been entrusted to take the game winning shot, and I missed. And I have failed over and over and over again in my life. And that is precisely why I succeed." – Michael Jordan

Although basketball is a team sport, it is worth noting that Michael Jordan took personal responsibility for losing almost 300 games. As the old sports saying goes, "There is no "I" in TEAM." Well, as Mr. Jordan has proven time and time again, there is an "I" in WIN, and it stands for Individual responsibility. Winning teams are made up of strong individuals willing to accept responsibility for their actions, but it takes a leader who is unafraid to assume full responsibility for the team's failures to guide the team to its full potential.

Summary

The vast majority of economists and business leaders acknowledge that a recession is looming, if not already here. The question is how severe it will be and how long it will last.

The FDIC's Quarterly Banking Profile for the 4th quarter of 2007 reinforces the idea that the delivery of trust services is going through a major transformation. Unless bank trust departments are willing to work with outside investment managers

and explore ways to provide an open architecture investment platform that takes advantage of custodial integration and data aggregation (shadow accounting) capabilities, they will be left with a smaller portion of a shrinking market for limited trust services.

Economic downturns provide a good opportunity for bank trust department executives to review their business models and focus on cleaning up some bad habits that may have crept in during a positive economic cycle. The business model should be reviewed from top to bottom, with an eye toward tightening up the revenue side as well as the expense side of the business. If a “best practices” or “practice management” program is not already in place, one should be implemented to provide management with an effective mechanism to continually monitor the business during good times and bad.

To sustain long-term success, change must become a part of management’s everyday culture – not just something that happens in times of crisis. Change must be encouraged at all levels of the organization and people must be free to pursue change without fear of failure.

When carefully considered and well planned, bold initiatives can pay enormous benefits in terms of financial success and personal gratification. It is not uncommon for PTG to make recommendations to prospective clients that can annually save tens if not hundreds of thousands of dollars. Some embrace the recommended changes and become energized by the challenge, while others fear the unknown and retreat from the possibilities. It isn’t hard to guess which trust department executives are the more successful.

The current financial markets have been surprisingly resilient to signs that we might be in the early stages of a long and difficult recession. As a result, trust departments have not yet felt the sting of lower top line revenue that accompanies a major down market. If Martin Feldstein is correct by stating that “The United States has already slipped into a deep recession that could be the most serious since World War II,” a sharp decline in the financial markets is inevitable – and top line revenue will follow.

Even if Mr. Feldstein's prediction proves to be significantly overstated and Mr. Greenspan's version of an "awfully pale recession" turns out to be the more accurate of the two, it is hard to imagine that the financial markets will not eventually react to the economic havoc being created by exorbitant oil prices that show no signs of retreating. And we won't even get into how disruptive political uncertainty can be for the financial markets.

Community banks and trust companies are well served by those trust department executives who are vigilant in managing their financial statements on a regular basis instead of waiting for a crisis that forces unwanted staff reductions and other cost-cutting measures. The time is right, both in terms of the economic cycle and because of increased competition, for trust department executives to examine current business practices and prepare for the transformation currently taking place in the delivery of trust services.

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About Private Trust Group of America

In an era of increased competition for providing trust and wealth management services, Private Trust Group of America offers efficient, cost-effective back office processing and administrative solutions that enable our clients to focus their attention on maintaining and building important client relationships. And in an era of declining knowledge of trust accounting principles, high employee turnover and low expectations, we provide experience, stability and unmatched attention to detail.

Private Trust Group of America's executives and professional staff are comprised of personal trust and wealth management experts who have more than 200 years of combined trust administration, operations and related industry experience. Our professional staff's average experience exceeds 20 years.

In addition to offering full technology-based administrative and operational support to trust companies, bank trust departments, family trust offices, law firms and similar personal fiduciaries, PTG provides the following services:

- Written business plans for de novo trust departments;
- Assistance with federal and state trust charter applications;
- Regulatory compliance matters;
- Written policies and procedures;
- Expert witness testimony;
- Design and monitor a customized Practice Management Program;
- Draft specific RFP guidelines and monitor the review process;
- Independent review of business practices and profitability issues;
- Trust department valuation for potential sales and/or acquisitions.

For more information about how Private Trust Group of America can help you succeed, please call 978-463-9099 and ask for Sandi Lotito, our Founder, or Ray Brearey, our Director of Sales & Marketing. You may also contact Sandi at sbl@privatetrustgroup.com, or Ray at rayb@privatetrustgroup.com.

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