



PRIVATE TRUST GROUP OF AMERICA

To Be Successful in the Expanding Directed Trust Market, Bank Trust Departments Must Become “Advisor Friendly”

“The number of millionaire households in the United States (those with \$1 million in net worth excluding primary residence) has risen for the fourth consecutive year to a record high of 9.3 million. Approximately 60% obtain investment advice from a professional financial advisor.” – Source: London-based market research firm TNS’ Annual Affluent Market Research Program (AMRP).

Much has been written in this space about the need to consider a new business model that relies on modern technology to access a wide range of outside experts and resources to supplement a trust department’s internal strengths and shore up its weaknesses. That model brings world-class investment and related services to the people served by small trust departments, and provides scalability that is difficult for local community banks to achieve independently.

As the forces of competition for asset management make it increasingly difficult for small community bank trust departments and trust companies to gain market share without increasing perennial deficits, it’s time to toss out some old biases and form new alliances. Registered Investment Advisors, Financial Planners, Brokers (“wealth management professionals”) and, to some extent, attorneys, accountants and family trust offices (“professional family advisors”) directly control much of the personal wealth that bank trust officers covet. As the projected “great wealth transfer” of our generation plays out, bank trust departments can expect to miss out on much of that business unless they are willing to conform to the more limited role of an administrative trustee called for by the increasingly popular “directed trust” or “directed trustee.”

What is a Directed Trust?

For purposes of this article, we will focus on personal trusts rather than on qualified plan trusts that come under the purview and slightly different standards of the DOL and ERISA. Generally, a directed personal trust is one under which the grantor or beneficiary has the power to direct that the trust's investments be managed by someone other than the trustee.

An important distinction should be made between a "directed trust" and the ability of a trustee to "delegate" investment responsibility. A trustee who delegates investment responsibility is held to similar standards of fiduciary responsibility (and liability) as if he/she directly manages the investments; whereas the investment advisor/manager assumes those responsibilities (and liabilities) under a properly drafted trust agreement that "directs" a trustee to use certain investment vehicles and/or specific outside investment managers.

Under a directed trust arrangement, the trustee still performs all other important functions necessary to carry out the terms of the governing trust agreement, including having frequent and necessary communications with the beneficiaries, but should refrain from commenting on the investments. To do otherwise could pierce the protective shield from investment liability and expose the trustee to unnecessary legal claims.

Institutional Trustees and Wealth Management Professionals – Friend or Foe?

Registered Investment Advisors, Financial Planners and Brokers all have close advisory relationships with some of the same people trust officers are courting for trust and investment services, but with one significant difference – most do not or cannot offer trust services.

It may seem that institutional trustees enjoy an advantage by being able to offer both investment and trust services, but a plethora of surveys and recent studies do not support that conclusion. In fact, most studies have found that the exact opposite is true – that

many clients prefer to use an institutional trustee for administrative purposes, but want the flexibility to choose their own investment manager.

“Of the 2,500 investors with assets of between \$1 million and \$10 million participating in a recent study by Boston-based Fidelity Registered Investment Advisor Group, 70% have had an advisor since an average age of 43. Within this group, 22% said that they get advice from independent advisors and they place more of their financial assets with independent advisors than any other category of advisor, an average of 56% of their assets. Over a third (34%) have two or more advisors.” – Source: Fidelity Registered Investment Advisor Group (FRIAG) Report.

Unlike previous generations, when wealthy families were generally more conservative investors and looked to the institutional stability of banks as their trustee and investment advisor/manager of choice, a common theme among today’s wealthy class is that they prefer a specialized approach that gives them the flexibility to choose their own investment advisors/managers. This provides clients with the best of both worlds – the comfort and stability of a local, regulated financial institution to serve as trustee and the broader benefits of being able to choose from a wide universe of investment advisors/managers with extensive research capabilities and contrasting investment styles.

This “separation of powers” has created a new paradigm wherein the trust market is being bifurcated into two distinct business lines. One provides the stability of an administrative institutional trustee with limited or no investment responsibility, and the other provides the flexibility of investment choice.

Acting as a directed trustee is not a new concept for many institutional trustees. Some already serve in those capacities, but usually not to the extent necessary to capture a significant portion of that business. To do that, institutional trustees must become “advisor friendly”, which means that they should not directly manage investments that

compete directly with the outside investment advisor's/manager's services and/or products. We have written before about the competitive disadvantages that community banks are under when their trust departments try to directly manage investments. The reasons are compelling from a liability perspective alone, and becoming an advisor friendly trustee just might be the impetus that is needed for a bank's struggling trust department to finally take that first bold step on the path to sustained profitability.

Turning Adversarial Relationships into Strategic Partnerships

Institutional trustees and outside investment advisors/managers may have more in common than they realize. Rather than view Registered Investment Advisors, Financial Planners and Brokers as adversaries, trust officers should cultivate strategic partnerships with them.

Contrary to common belief, accepting an occasional trust client from one of these wealth management professionals – regardless of how many times the two of you play a round of golf together – is not a strategic partnership. At best, it is a “partnership of convenience” and, at worst, you get the referral by default. That is not the way to cultivate a strategic partnership that could have such a far-reaching and positive impact on your respective businesses and on the added value it brings to your clients.

For a true strategic partnership to succeed, all parties to the transaction must have a vested interest in the outcome – which, first and foremost in the trust business, means doing what is best for the long-term interests of your client. This is precisely the reason it makes so much sense to turn what has always been considered an adversarial relationship between institutional trustees and outside wealth management professionals into a successful strategic partnership. The institutional trustee and investment manager benefit from sharing clients and becoming strategic partners, and clients benefit from the services and specialized expertise each strategic partner brings to the relationship.

The Competition

Many national trust companies and large brokerage firms provide some form of directed trust services to Registered Investment Advisors, Financial Planners and Brokers, but truly advisor friendly directed trust services are heavily concentrated with just a few national providers. Given the choice between an advisor friendly directed trustee located half way across the country and a local community bank that directly competes for his/her business, is there any question who the investment advisor/manager will choose?

At the moment, there is not much local competition for advisor friendly directed trustee business unless you happen to be in the same neighborhood as one of the half dozen or so national providers of such services. Chances are pretty good, in fact, that if your institution were to take the modest steps necessary to become an advisor friendly directed trustee, you could add a significant new line of business that would have an immediate and positive impact on bottom line revenue.

Some Barriers to Providing Advisor Friendly Directed Trust Services

The most significant barrier to providing advisor friendly directed trust services has already been mentioned, which is that the institutional trustee should not directly manage investments. Since managing investments is perceived as a direct threat to their client relationships, most investment advisors/managers will avoid, at all costs, directing business to any institutional trustee that directly manages investments. The obvious way around this for institutional trustees is to have an open-architecture investment environment whereby they use a variety of external advisory relationships instead of an in-house investment advisory staff.

Another significant barrier is that most investment advisors/managers insist on controlling where each client's assets will be held for custody purposes, which puts the trustee in the uncomfortable position of not having direct, real-time access to account information. This problem is compounded when several different custodians are used by the same

investment advisor/manager, making the “shadow accounting” and reconciliation process even more cumbersome.

Modern technology provides the resources to manage these different custodial relationships much more efficiently and cost effectively than in the past. Data aggregation and custodial integration software is now available that will download transactions and asset positions from various custodians via a secure Internet connection and dump that information into spreadsheets or word documents. More sophisticated technologies will go one step further and upload the information into some trust accounting systems on a daily basis, but the information must still be manually reviewed for mapping issues and reconciled to the custodian’s positions.

These are far from insurmountable barriers. In fact, as we have written elsewhere, the first (providing an open-architecture investment platform) can be turned into a marketing advantage – and the second (data aggregation and custodial integration) can easily be remedied with software tools that are proven and readily available. An open-architecture investment environment, combined with advisor friendly directed trust services that include multi-custodian data aggregation and account consolidation capabilities, should have broad appeal among community banks’ trust departments.

The Economics of Becoming an Advisor Friendly Directed Trustee

Based on our own experience of providing similar services to clients, institutional trustees offering directed trust and data aggregation services can expect to add double digit bottom line revenue to their trust department’s income statement. The economics of becoming an advisor friendly trustee are enhanced even further if it is treated as a separate business line that focuses on the advantages of open architecture investment capabilities and consolidated reporting options for clients with assets held by multiple custodians.

Directed trustees are expected to discount their normal fees by about 50% if they have no investment responsibility, which is a small price to pay for being relieved of the heavy staffing costs, extra regulatory oversight and potential liability associated with poor investment advice or performance. As with other trust related services, pricing can be based on market value with a sliding scale to reflect the size and uniqueness of each relationship. We have seen fee schedules ranging from 65 bps on the high end to 15 bps on the low end of the scale. As with other services, the fee structure can be designed to discourage smaller, unprofitable accounts. The fees charged by most major providers of advisor friendly directed trust services seem to fall in the middle of that range.

Although the data aggregation and custodial integration technology is readily available, it does not operate as smoothly as advertised. Each custodian has its own set of data collection methods and its own way of describing certain transactions, which presents some interesting challenges when trying to map data and transactions to accurately conform to a bank's own internal standards for client statement purposes.

After meeting the challenges of mapping data and transactions for a particular custodian, it will be necessary to monitor daily downloads and exception reports in order to reconcile the custodian's records with those of the bank. This process is magnified as the number of different custodians is expanded, and can become very labor intensive.

The economics of offering advisor friendly directed trust services with data aggregation and custodial integration capabilities are most compelling when an outside service provider is engaged to coordinate information between various investment advisors, their custodians and the bank. An outside service provider has established relationships with multiple custodians, so many of the data mapping and related issues have already been resolved. Furthermore, an outside service provider allows a bank to enter the business without incurring the significant start-up costs of hiring and training

additional staff to integrate and oversee new software applications, and monitor the various outside custodial relationships.

These service providers already have the technology in place, have been through the data and transaction mapping process with most major custodians and have trained personnel dedicated to monitoring the daily reconciliation process for each custodian in their universe. Moreover, they can customize customer statements to match those already being provided by the bank, thus eliminating the need to change existing trust accounting systems or to develop a costly interface that would require additional staff to maintain and monitor.

Advisor friendly directed trust services can be a forceful new marketing advantage for community banks – especially when combined with the added-value of data aggregation and custodial integration services that provide consolidated reporting capabilities for clients’ assets held with multiple custodians. Services can be structured as a separate business line within an existing trust department with no upfront costs and without disturbing trust accounting relationships that are already in place. Advisor friendly directed trust services also provide an excellent opportunity to build strong, mutually beneficial strategic partnerships with other wealth management professionals that control a large segment of the investment advisory business.

Although the advisor friendly directed trustee business is still in its infancy, several non-bank financial institutions have already entered the market and others are thinking of doing so. As the two reports cited in this article suggest, wealthy individuals look to investment advisors to manage their assets – not to banks. If these investment advisors cannot find advisor friendly institutional trustees to partner with, they will continue to set up their own trust divisions – and banks will continue to share a smaller piece of the trust services pie.

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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.

CONTACT INFORMATION:

Sandra B. (Sandi) Lotito

Founder

Private Trust Group of America

29 Water Street – Suite 215

Newburyport, MA 01950

P 978.463.9099

F 978-463-9499

Email: sbl@privatetrustgroup.com

Alexander C. (Sandy) Forbes

Manager, Data Aggregation Services

Private Trust Group of America

29 Water Street – Suite 215

Newburyport, MA 01950

P 978.463.9099

F 978-463-9499

Email: sandyf@privatetrustgroup.com

Website: <http://www.privatetrustgroup.com>

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