



PRIVATE TRUST GROUP OF AMERICA

## A New Paradigm For Providing Trust Services is Emerging

By: John Larrabee

Note from the author: This is the second of two related articles in which I have attempted to expose some areas of concern facing community bank trust department executives in today's highly competitive marketplace. The previous article, "Some Hard Truths About Community Bank Trust Departments", confronted the "Profitability Myth" and similar challenges that trust department executives must overcome to be successful.

This follow-up article examines an emerging new model of providing trust services. The new model will require a sharply focused plan that allocates diminishing financial resources on the human capital necessary to manage client relationships, rather than on other high-cost, high-maintenance areas that do not add directly to top line revenue.

### Declining Profits, Increasing Expectations & Unwanted Competition

Bank trust departments have never been known for providing a strong contribution to their bank's bottom line. Now, with ever-increasing competition that is expanding consumer choices and narrowing profit margins, even once profitable trust departments are struggling to breakeven. The red ink will flow at an increasing rate until management acknowledges that the old business model no longer works in the new world of high-speed technology and rapidly changing demographics.

The term "trust department" has already been replaced with "trust & wealth management services" or similar terms in many banks, which is both a reflection of the diminishing use of trusts and the increasing demand for pure asset management. Separately managed agency and retirement account assets are growing at a much faster rate than trust assets, which accounts for the shift in

emphasis. As a result, bank trust departments will have to focus more on gathering other non-trust related assets under management and redefine the way they provide trust services.

Ironically, the shift in emphasis from simply providing trust services to providing a wide range of asset management services will make bank trust departments more profitable if they take advantage of the opportunity. It will require a major overhaul in the way they currently operate, but it can be done.

### The Diminishing Advantages of Small, Community Banks

Contributing to the necessity of changing the way bank trust departments operate is the fact that it is no longer an advantage to be a small, local community bank. Community banks have appropriately capitalized on the slogan that they are "...small enough to care and large enough to make a difference," which is based on the theory that community banks are managed by business people with deep roots in the local community, thus giving them an advantage over larger banks that may have local branches but no autonomy.

That dynamic has drastically changed as new technology has allowed a younger and highly mobile generation of beneficiaries to depend less on local decision-makers. Now, local branches of larger financial institutions have access to the full range of products and services that are available at the home office, and decisions are either made at the local branch or through an expedited process from the home office that make them indistinguishable. As a recent participant in a focus group sponsored by the asset management division of a major international insurance company, I got the clear message that the community banking market is becoming an inviting target for larger financial institutions. This particular company is planning to focus specifically on the community bank trust market by accepting accounts with as little as \$50,000. It is the beginning of a trend that community banks should not take lightly.

The fact that many larger financial institutions are lowering their sights and aggressively pursuing traditional community bank trust departments was brought into full focus on a recent trip to a small, New England town where I counted

eight branch bank offices (including one each for Bank of America and Wachovia) and branch offices for two national brokerage houses within a six-block area on Main Street. Each of the branch offices had the term “wealth management” or similar services prominently displayed in the window.

### Reclaiming the Bank’s Fiduciary Responsibility

The great stock market boom that began in the 1980’s (followed by the broad acceptance and eventual adoption of changes to the Prudent Investor Act in 1994) changed the typical trustee’s role from one of wealth preservation to one of wealth enhancement. This dynamic shift in emphasis has resulted in increased dependence on asset managers to produce superior investment returns, and reduced expectations on the trustee’s ability to manage investments or the investment process.

Unfortunately, investment management and the unprecedented focus on short-term investment results often places fiduciaries in the unenviable position of acquiescing to the current demands of beneficiaries while risking some of the long-term goals established by the trust. This often results in the trustee abrogating one of its most central roles as a fiduciary, which is to manage the investment process.

By taking a more active role in the investment process, trustees will once again reclaim their fiduciary oversight responsibility and regain their rightful role as “gatekeeper” of the client relationship. For this to happen, it will be necessary to supplement the bank’s internal investment program with a wide range of external investment options that include access to world-class investment managers.

### Re-Engineering the Staff

Because trust services have taken a back seat to investment management services, bank trust officers must reassert themselves to the forefront of managing key relationships by becoming the “gatekeeper” of those relationships.

Individual and institutional trustees hold a unique position of trust that sets them apart from most other family advisors. It is a position that offers a strong opportunity to become the key decision maker in all matters relating to their clients' financial, business, personal and family affairs.

Being a trustee must not be confused with providing trust services. The former requires the unique personal and institutional qualities of personal trust, integrity and demonstrated competence; the latter is a commodity that can and should be outsourced in order to gain the advantages of specialization and cost reduction through service aggregation and scalability.

To compete with larger financial institutions at the local level, community bank trust managers must rethink their staffing priorities and needs. If a staff position and its related costs cannot be measured in terms of direct revenue production, it is probably unnecessary.

The emerging model for providing trust and related asset management services will include frontline positions staffed by well-educated, experienced and knowledgeable relationship managers who understand basic estate planning terms and concepts; have a general understanding of, and are conversant in, broad investment terms such as risk, diversification, asset allocation, etc.; and can make clients feel comfortable in the knowledge that the bank will not only provide strong institutional support and safety, but will also provide access to some of the best financial products and services available.

The only support staff positions necessary will be those that can directly assist the frontline relationship managers in their revenue generating activities. All other support staff positions and activities, including basic trust operations and most investment management services, will be outsourced.

### Focus on Internal Strengths and Establish Priorities

The three main ingredients for operating a successful (and profitable) trust and wealth management services group include: 1.) A strong business development/client relationship management team; 2.) A sound investment

program, including access to world-class investment management professionals; and 3.) A reliable operational and administrative support structure that exceeds clients' expectations and meets regulatory guidelines.

It is unusual to find a bank trust department or any other wealth management organization that performs all three functions successfully, or with a high degree of efficiency. It is clear, however, that if the organization cannot develop a strong business development/client relationship team it will not be necessary to consider the remaining two ingredients. Business development and managing client relationships must, therefore, become the bank's top priority – and, in some cases, its only priority.

One of the greatest fallacies of managing community bank trust departments is the idea that in-house investment management is a client-driven necessity. Except in rare cases, it is not only unnecessary it subjects the bank to needless risk at a time when access to world-class investment managers is so easily obtainable. Does that mean that banks must let their investment managers go? Not if they would be a good frontline relationship manager as described earlier.

It is not practical to expect clients to be satisfied with the results of community grown, in-house investment managers. Notwithstanding the fact that some community banks can and do provide reasonable investment returns from internal resources, clients expect (and in some cases demand) to have access to some of the best and brightest investment management expertise available. Community bank trust departments must, therefore, offer access to a greater range of outside investment managers as a way to retain existing clients and attract new ones.

If the organization has a sound internal investment management group it should be complemented with world-class investment managers that are easily accessed through key third party providers with open architecture and data aggregation capabilities. Alternatively, the entire investment process is capable of being managed by third party relationships, thus redirecting even more valuable time and financial resources to the organization's number one priority – developing a strong business development/client relationship team.

A sound investment program should not be limited to the strengths and special expertise of internal investment managers alone. Complementing it with outside investment managers has many advantages and is a great way for banks to differentiate their services from local competitors by introducing them to world-class investment expertise that they cannot access directly on their own.

Another common misconception is the idea that outsourcing administrative and operational functions results in losing control of those processes. Actually, studies have shown that just the opposite is true. Outsourcing back office functions allows management to focus more attention on their oversight responsibilities, including internal controls, policies and procedures, rather than on the day-to-day processing activities. It also provides management with the time necessary to focus on strategic business planning and new business development opportunities.

It is imperative for the organization to undertake a candid assessment of its ability to provide these three main ingredients from within the organization. Focusing on internal strengths and establishing priorities will help define the future goals of the organization and determine its potential for financial success.

#### Create a Fee Structure Based on the Value of Services Provided

Fees should be based on the value of services provided, not on the fee schedule of the bank down the street. In fact, a strong argument can be made for having a higher fee schedule than the bank down the street – provided a client can be presented with a reasonable case that the fee is justified by superior products and/or services. Clients have a good understanding of the value proposition in financial transactions, and when it comes to such important matters as whom to entrust with the responsibility for managing their financial security most will not base their decision on price alone.

Once a fair and reasonable fee schedule has been adopted, discounts should be used sparingly, if at all. There are obvious situations and many good reasons to apply discounts, but undercutting a competitor's fee is not one of them. It is

always better to explain why your bank's fees are higher than to agree to a discount that results in a bad business decision. If discounts are appropriate, make sure they have a sunset provision and are not open ended.

Another reason that discounts should be discouraged is that, over time, clients expect more and more services to be provided under the discounted fee structure. This is often referred to as "service creep", and is an insidious threat to bottom line profitability because of its stealth-like ability to consume time and resources beyond the scope that was originally intended. If discounts are used, it is vitally important that a well-defined pricing structure specifies the services to which the discounts apply – and that the relationship is scrupulously monitored to guard against service creep.

One of the most common reasons to negotiate fee discounts is when outside investment managers are used in lieu of internal managers. Unless the client takes full responsibility for selecting the outside manager and specifically holds the bank harmless from investment decisions, no discount should apply – even when the bank utilizes independent, outside managers.

Part of the bank's responsibility, as trustee, is to manage the trust's assets in accordance with the Prudent Man Rule. One could certainly make a valid claim that it would be more prudent to select investment managers from of a vast range of quality investment advisors rather than relying solely on the experience and expertise provided by investment managers at a local community bank.

The rationale for not discounting the fee in such situations is that it is still the bank's responsibility to work with the client and beneficiaries to develop standards of risk tolerance, asset allocation models and monitor the performance of the outside managers – and that the bank has ultimate responsibility, as trustee, for the investment process. The difference in historical performance statistics and potential for superior forward returns is often enough to justify the added cost of hiring the outside managers.

## Managing Costs

The new model for providing trust services requires aggressive cost cutting measures and vigilant oversight of the budget process. Staffing costs typically represent 75 – 80% of a trust department's operating budget. Concentrating on filling the frontline staff positions and limiting other non-revenue related positions outlined under the previous section, "Re-Engineering the Staff", will significantly reduce that percentage. Moreover, reallocating financial resources to frontline positions dramatically increases top line revenue potential, thus significantly reducing overall operating expenses as a percentage of gross revenue.

Third party service providers can offer substantial opportunities in terms of access to products and services that are not normally available to smaller organizations, as well as significant cost savings because of service aggregation and scalability. However, those relationships can prove very costly if not monitored properly. For example, most third party contracts contain an automatic renewal clause that extends the contract for an additional term if the vendor is not notified of the bank's intent to not renew the contract within a specified time (usually 90 days, but as many as 180 days).

The automatic renewal clause is never an issue until a bank decides to perform due diligence and decides to terminate the contract with the existing vendor. Invariably, someone forgets about the notification period or fails to send a notice of intent to not renew – so the bank is then faced with buying out the remaining term of the contract or waiting until the end of the renewal period.

If a vendor insists on an automatic renewal clause, simultaneously sign and attach to the contract a "Notice of Intent Not to Renew", which will eliminate an oversight that could cost the bank tens or even hundreds of thousands of dollars.

## Profitability – From Myth to Reality

The following hypothetical example provides a glimpse into how the new business model could turn profitability from myth to reality:



	<u>Old Model</u>	<u>New Model</u>
Assets Under Management	\$100 million	\$100 million
Number of Accounts	200	200
Estimated Annual Revenue @ 75 bps	\$750,000	\$750,000
Costs:		
Salaries & Benefits:		
Department Manager	\$175,000	\$175,000
Sr. Trust Officers	(3) 240,000	(4) 320,000
Admin. Assistants	(2) 80,000	(2) 80,000
Investment Officer	150,000	0
Admin. Assistant	40,000	0
Operations Staff	(3) 120,000	0
Direct Costs:		
Accounting Systems & Support*	100,000	0
Audit (External & Internal)	75,000	75,000
Outside Investment Managers**	0	0
Outsourced Operations*	0	85,000
Indirect Costs:		
Overhead (allocated)	25,000	15,000
Efficiency/Opportunity***	<u>200,000</u>	<u>(200,000)</u>
Total Costs	<u>\$1,200,000</u>	<u>\$550,000</u>
Operating Profit (Loss)****	<u>(\$450,000)</u>	<u>\$200,000</u>

\* Includes custody, pricing, statement printing & mailing.

\*\* Assumes better management and improved performance justifies asking the client to bear the full cost of outside management.

\*\*\* Improvements to efficiency resulting in new business opportunities of \$25 million in AUM within first year. Shown here as an expense offset for illustrative purposes, but would actually represent an increase in top line revenue.

\*\*\*\* Potential for higher profit margins exist under the new model if greater emphasis is placed on new business generation by frontline relationship managers through an incentive bonus program.

In the above example, four senior relationship managers and two administrative assistants should provide adequate coverage for existing business levels with room for about 50% growth in new business. Senior relationship manager to administrative assistant ratios should remain at 2:1 as new business is added.

Concentrating financial resources on frontline positions that have direct client contact and new business responsibilities will change the dynamics of the department from reactive to proactive. And a department-wide incentive bonus program that emphasizes new business development and bottom line responsibility will reenergize the entire staff and encourage a new spirit of entrepreneurship.

Turning profitability from myth to reality can be easier than one might imagine. It does not require an immediate and irreversible change, but it does require an acknowledgement that change is necessary and inevitable if one intends to compete effectively in today's marketplace. The key lies in the strength of management's resolve to make the necessary changes and the determination to see them through. Ironically, the arrival of community banks' larger competitors in their back yards may have provided the impetus for such change – and the potential for greater profits.

*This article was submitted by John Larrabee, managing partner of a family trust practice and an advisor to Private Trust Group of America. John can be reached at his Charlotte, North Carolina office: 704-987-0875, or via email at: [johnl@northstarfinancialgrp.com](mailto:johnl@northstarfinancialgrp.com).*

### **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 & General Manager  
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](mailto:sbl@privatetrustgroup.com)  
Website: <http://www.privatetrustgroup.com>

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