Private Trust Group of America

Some Hard Truths About Community Bank Trust Departments

By: John Larrabee

Note from the author: For more than 35 years I have provided personal trust and estate planning services to doctors, lawyers, corporate executives, business owners, wealthy individuals and their families. More recently, in my capacity as an advisor to Private Trust Group of America, I have had the privilege to observe how similar services are provided through community bank trust departments.

My observations are not based on data obtained from scientific polls or studies, which could be skewed by the way questions are asked and a tendency on the part of some trust department managers to inflate their strengths and overlook their weaknesses; but rather on candid personal conversations with key bank executives and other wealth management professionals from different parts of the country.

This is the first of two articles in which I will share some of the more common problems facing community bank trust department executives in today's highly competitive marketplace. A follow-up article entitled *"A New Paradigm for Providing Trust Services is Emerging"* will challenge some of the traditional ways of managing bank trust departments and suggest a more modernized approach to deal with the substantial challenges that lie ahead.

The Profitability Myth

Among some of the more fascinating things I have learned from talking with community bank trust executives is that, in theory at least, they maintain two sets of accounting records. One set is used at conferences and in other peer group settings where virtually every trust department executive will tell you that he/she runs a profitable department; and the other is used in private conversations

when a trust department manager will reluctantly admit that his/her department "is not quite profitable." On rare occasions, one will acknowledge that his/her department "hasn't made a profit in 15 years," or has "never been profitable."

Of one thing we can be sure. Profitable or not, competition will continue to shrink profit margins and increase the flow of red ink unless a fundamental change is made in the way community bank trust departments manage their business.

Although I have heard that it can take as much as $1 billion of AUM to breakeven, there is no magic number to point to that guarantees profitability. Private trustees and family trust offices can generate profits on as little as $50 million in AUM, but they are not burdened with the high regulatory costs that community banks must endure. It would be hard to imagine that regulatory costs alone would not increase that threshold by a multiple of two or three, which would make breakeven a reasonable expectation at around $100 - $150 million in AUM.

The fact that two theoretical sets of books exist in most community bank trust departments suggests an inability to admit or to confront the failures that contribute to the lack of honesty in dealing with the issue. The conflict between personal perception and institutional reality must be reconciled if the department is to truly become a profitable performer for the bank. Privately concealing or failing to acknowledge the problem will not make it go away for the institution.

Profitability for small trust departments is attainable (even in a highly regulated environment), but only if senior management is willing to consider scrapping the traditional trust business model for a new one.

Fees

The profitability myth is supported by the fact that most banks' trust departments have absolutely no sense of how to create a fee structure based on the value of

services provided, or that can be easily explained and justified to astute clients. Instead, they rely on artificial ceilings created in another era, with only a vague reference to the intrinsic value of the services being offered.

Unfortunately, the trust profession has allowed fees to be hijacked by money managers – but community bank trust departments seem to be more adversely affected by this phenomenon than other professional trustees. Bank trust departments should not be embarrassed or afraid to charge a reasonable fee for trust services. More importantly, they must make a more serious effort to explain the services that are being provided so that clients can understand the value proposition. Clients will be less hesitant to pay more for services if it can be shown that there is value added.

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 by encouraging trustees to invest in hedge funds, options, derivatives and other non-traditional, alternative investments.

This dynamic shift in emphasis from wealth preservation to wealth enhancement 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. As a result, community bank trust departments have been placed in the unenviable position of keeping highly compensated investment professionals on staff, thus driving up costs; or using outside investment managers, in which case the bank's trustee fees are often expected to be reduced.

Trustees must regain the compensation high ground by reasserting control of the investment process, including any selection of outside managers, which will provide them with the leverage necessary to charge higher fees and gain better control of investment related costs.

The leaders of community bank trust departments too often allow pricing to override sound business practices. Fees are generally based on an artificial

ceiling according to prevailing rates at other fiduciaries in the area, rather than on the value of the services rendered or the cost of providing them.

Contributing to the self-imposed ceiling on top line revenue is the fact that many bank trust officers and department heads readily admit to offering steep discounts for no other reason than to keep business from going to a competitor. Discounts are sometimes necessary – but without a logical reason and established fee-setting guidelines, management loses control of its ability to generate profits. If the discount results in taking on unprofitable business, it may be advantageous to let a competitor carry the burden of that financial loss.

Costs

Another fascinating discovery is the ambivalent approach that bank trust department managers take when it comes to cost containment. It is not unusual to hear a trust department manager admit that his/her department is overstaffed, or that he/she inadvertently allowed a third party vendor contract to rollover for another 3 – 5 years when a suitable alternative could have been negotiated at potential savings of tens of thousands of dollars, or even more, over the life of the contract.

This ambivalence appears to be more a result of lack of accountability from the bank's Executive Board and Board of Directors than from any desire to intentionally conceal the fact that the department is not operated as profitably or as efficiently as it could be. There are growing signs, however, that some banks (and even some regulators) are demanding more bottom line accountability from their trust department managers.

Most trust department managers simply do not know whether their department is profitable or not. Some limit costs to easily determinable fixed, hard dollar costs, such as salaries, accounting systems and third party service providers, etc., and do not include variable, soft dollar costs that often get absorbed by other areas of the bank. Some may include a rudimentary allocation of fixed overhead costs such as rent, utilities, insurance, etc., but rarely are such soft dollar costs as

employee turnover, absenteeism, internal training and other inefficiencies considered.

Also often overlooked is the added burden placed on non-trust department personnel and integrated banking systems that process some bank/trust department activities, as well as the properly allocable costs of bank audits, attorneys' fees and directors' and executive management's time consumed on matters relating to the trust activities of the bank.

The value of any profitability study relies on establishing a workable and meaningful analysis that accounts for all of the costs of operation, not just those that are most visible and easy to calculate. To do otherwise would be a dereliction of the manager's responsibilities and render the study meaningless.

Generational Transition

The traditional trust business model focused on meeting the needs and expectations of an older generation – a generation that could still remember the financial hardships of the Great Depression, and one that lived under the social and economic clouds of World War II.

The earlier model, which represented fiscal and social conservatism, must now be replaced with one that meets the needs and expectations of a new generation – a generation that not only has experienced unprecedented economic growth and prosperity, but one that has grown up in an environment of privilege, instant gratification and entitlement. Almost daily advances in technology reinforce those needs and expectations, thus creating a generation with virtually unlimited information at its disposal and a limited sense of the historical perspective of financial uncertainty and hardship.

This new generation of trust beneficiary is much less likely to passively sit back and wait for a trust distribution check or account statement to arrive in the mail. They want the distribution electronically transferred to their account and they want the ability to access their information anytime, anywhere, 24/7.

Technology has enabled a new generation of beneficiaries immediate access to information which, in turn, has provided them with unprecedented power to question decisions and demand results.

With so much information at their fingertips, beneficiaries present a new set of challenges to fiduciaries. Trustees must be much more proactive than in the past, which means being more engaged in managing clients' expectations and developing long-term client relationships. (For more on this subject, see PTG's recent article "Managing Wealth Means Managing Expectations.")

Policies & Procedures

My involvement with Private Trust Group of America has given me a much greater sense of the regulatory burden under which bank trust departments operate, and a much better appreciation for the importance of establishing critical policies and procedures.

For the most part, community bank trust departments seem to be very sensitive to the regulatory requirements of establishing and maintaining proper policies and procedures. What is less certain is whether or not those policies and procedures are tested on a regular basis. Having policies and procedures and not following them can be at least as costly as not having them at all.

The generational transition and accompanying access to information mentioned above have combined to give trustees an even greater need to have policies and procedures in place and to be sure they are working properly. A disgruntled beneficiary, a hungry litigation lawyer and a sympathetic jury can virtually destroy the reputation of a trust officer or financially cripple a bank if someone forgets to follow or ignores bank policies and procedures.

Even a small lapse in following established policies and procedures can be devastating. Consider an out-of-court settlement or enforceable judgment of $2 million, which would not be unusual given the financial exposure of even the smallest trust department today. Legal, accounting, expert witness testimony and staff time could easily add another $500,000 to the financial exposure.

Insurance will usually not cover a claim that is subject to a failure on the part of the trustee to have adequate policies and procedures in place or a failure to follow established policies and procedures. Therefore, the bank would have to pay the settlement or judgment out of operating income. Assuming a net operating margin of 10%, the bank would have to generate $25 million in revenue just to cover the judgment and related costs. That could be a costly lesson for even a minor transgression.

Developing and implementing policies and procedures deservedly receives a lot of attention from bank personnel and regulators, but they probably need to be probed and tested much more than is currently the case. As mentioned earlier, the new generation of beneficiaries is not as passive as those of prior generations, and it would take only one minor misstep to convince a disgruntled one to pick up the phone and call an aggressive litigator.

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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.

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