A Trust Veteran's Perspective on Trust Services Today

Background:

The traditional banking/ trust industry is in a state of deep confusion, some would say crisis, in the execution of its fiduciary duty to trusts, especially that of strict loyalty to trust customers. Look around you. One day it's the Trust Department and the next it's the Private Customer Wealth New Rich Group or some such name intended to imply exclusivity, or some even reverting to the name "Trust Company" to disguise a new regimen. Various institutions are constantly reinventing and reorganizing themselves in hopes of capturing a greater share of the customers wallet. Driven by the need to increase fee based income versus the precarious historical path of income generation through interest margin spreads, these institutions seek to sell other services to each customer, banking or trust, at times without determining the suitability of those products or services for the customer. This zeal is further exacerbated by the need to increase shareholder value, which in some cases has been influenced by aggressive acquisition strategies and managers seeking to feather their own financial nests with lucrative severance and compensation packages. The need to create ever greater profits has been divorced from the banks legal obligation to faithfully execute their fiduciary duty to trust customers. Merger and cost cutting trends have resulted in the "retirement" of experienced trust officers and replacement by young sales trained "personal representatives."

In earlier times, when corporate trustees were guided by the *Prudent Man Rule* and the variety and proliferation of investment vehicles was more limited than today, the *Chinese Wall* was honored, [keeping trust information confidential from the rest of the bank,] breaches of fiduciary duty were limited in scope. If a corporate trustee was failing to provide investment returns consistent with the Prudent Man Rule, this could be fairly easily demonstrated and the trustee could be removed, albeit through a public, costly and seldom used court proceeding. The vast majority of breaches of fiduciary duty were settled before they reached the courthouse steps, thus keeping the bank's reputation "inviolate." The era and concept of the Trust Protector had not yet arrived. Also, most trust documents of that era made no provision for a beneficiary to remove a corporate trustee without court action of some sort. Recently, Missourians have seen a Bill to allow beneficiaries under certain circumstances to remove corporate trustees, go down to defeat at the hands of the big banks and the Missouri Bankers Association.

The Slide Into Self-Dealing:

Somewhere around the mid-1960's with the creation of bank holding companies, mergers and consolidations, there began a slide into the situation we witness today. Corporate trustees began to realize that economies of scale were available to them, especially in the investment of trust assets via commingled funds, a/k/a common trust funds (CTF) for personal trust accounts or collective funds for institutional trust

accounts. Operating similarly to a mutual fund, common trust funds permitted the pooling of assets and the use of participations or units to be held by the trusts. Unlike mutual funds however, the common funds usually carried no separate management or operational fees but they were unavailable to custodial accounts and non-trust customers. Further, the corporate trustees were not permitted to advertise the financial performance results of these funds to the general public. If properly invested, a common fund could have many benefits for both the trusts participating in them and for the corporate trustee. For instance, in small accounts, diversification could be achieved where it might otherwise not be possible and the economies of scale could keep costs in check, allowing banks to accept and manage smaller accounts. To successfully and efficiently operate common funds banks do need size.

The most commonly perceived failing of CTFs is that they produced mediocre results. It is a fact, borne out by an AIMR Survey, that most banks with their restrictive salary structures cannot hire and maintain the best and brightest asset managers. Although banks valiantly protest these accusations with various statistical reports and moving benchmarks, the perception exists to this day. Some say "where there is smoke, there must be fire." The taxation of capital gains is another shortcoming of CTFs which bankers do not wish to discuss.

The trend to use common trust funds had even more benefits to the corporate trustees than the customers. It allowed banks to put more accounts under the management of a single individual. Previously, accounts were handled by a trust administrator and a portfolio manager. The portfolios assets generally consisted of discreet securities requiring individual attention. With the common fund, the bank could have a single portfolio manager handle an entire fund, shared by a large number of accounts. Now the bank needed only the trust administrator, possessing limited investment knowledge, for contact with the grantor or beneficiary. The wonders of this phenomenon did not end here for the banks. Not only could they eliminate the need for "duplicate" portfolio managers, they could, they falsely concluded, double, triple or even quadruple the account load of a trust administrator. It was possible to do this within the regulatory scheme and remain on the good side of the law. The consequences to the customers were foreseeable. Mediocre investment performance and less customer service were just two of the results. Many attorneys and advisors to families recognized these shortcomings and, at least for their wealthier customers, began to find alternatives to the local bank or trust company.

Banks seeing the rapid growth that took place in mutual funds were slow to take up the challenge. However, once the idea took hold, they became masters of by-passing the then prohibitions of the Glass-Steagall Act and teamed up with "distributors" with whom they could share their ill gotten gains. Banks seized the opportunity to exploit their fiduciary customers by either converting their CTFs into mutual funds or forcing new small (generally under $750,000 in assets) customers into proprietary mutual funds. If state law permits, some banks take fees at both the mutual fund level and at the account level.

Mired in Self-Dealing:

Smaller institutions using outside advisors, usually opt for mutual funds provided by a few companies which cater to the trust market segment. True, the choices are somewhat more varied and also offer manager diversification, but their investment performance results are not spectacular nor any better than some of the banks with proprietary funds. To add injury to insult, many of these banks charge a trustee's fee commensurate with their competition which does not use such mutual funds. The customer whose account hold mutual funds may also be charged an investment management fee at the mutual fund level where it is taken from the fund's assets and thus never seen by the beneficiary. This practice is known as double-dipping. Two investment management fees are charged, one at the trust level and another at the mutual fund level. In many instances, banks caused laws to be passed by state legislatures making this scheme legal and unassailable by even the bank regulators who defer to local law in such matters.

Some conscientious or perhaps fearful corporate trustees have attempted to avoid this issue by either rebating the investment management fee or investing in a class of shares that charge no such fee. The latter is often the case when the bank is also the manager of its own proprietary mutual funds. However, this raises additional questions involving self-dealing by the banks utilizing mutual funds and particularly those using their own funds.

First, besides the investment management fee, there are inherent in every mutual fund certain operating expenses not experienced in discretely managed portfolios or common trust funds. Generally, these operating expenses will be in the range of 3/10% or 30 basis points in a typical equity mutual fund. They cover such items as asset custody, distribution and marketing expenses, fund legal and accounting expenses, directors' fees, etc. Since, in most instances, these fees go to third parties, not the bank, they are not rebated to the trust account. This is seldom clearly disclosed to the grantor or the beneficiaries, but it does diminish the investment returns of the trust account.

Second, is the matter of the use of the rebated fees from the time they are charged against a trust accounts until they are returned to the accounts from which they are taken. Considering that many bank operate mutual funds measuring in the billions of dollars of assets, having the use of say 3/4% on several billion dollars for a month is truly significant, especially if it can be done month after month.

Third, and rarely disclosed, is the fact that a portion of the mutual fund operating expenses, usually associated with the distribution and marketing expenses, often gets rebated to the bank for use in advertising or otherwise promoting its mutual fund, frequently to its retail customer base. Again, the absolute dollars to the bank are significant. Thus, the bank is burdening the very customers to whom it owes the highest level of fiduciary duty by having them pay for marketing associated with selling its mutual funds to retail customers.

There is little, if any, evidence of the advantages of trust accounts owning proprietary mutual funds as espoused by the banks. Diversification and better capital gains management, are all available under common trust funds and at lower fees to the customer. An oft touted benefit to customers is portability, the ability to move mutual funds to non-trust accounts or individuals. It is more illusory than helpful to the customer, while greatly benefiting the bank. Through this mechanism the bank hopes to retain assets that would otherwise be lost through distributions from trusts. Mediocre investment performance and more fees are the true reality of the introduction of mutual funds to trust accounts.

Banks have been steadfast in their shunning of outside investment advisors, save for the smaller institutions who by necessity used outside providers. The customers only choice is the bank's asset management, style, performance and personnel. Again, most trust beneficiaries are stuck with the named institution unless they want to litigate the matter. As an aside, it is important to note that in most states a trustee can use trust assets to fund its defense of its handling (mishandling) of the trust, unless a court says otherwise. No matter which way the beneficiary turns, he is at a real disadvantage to the bank. Today, the broad adoption of the Prudent Investor Rule gives trustees permission, if not the mandate, to hire outside investment advisors if the situation demands it. Successive years and even decades of investment under performance, it seems, will no longer be tolerated. The question remains, how long will it take for banks to adopt the new investment policy?

Adding More Conflicts of Interest to the Mire:

On November 12, 1999, the Graham-Leach-Bliley Act was signed into law. Although it is intended, among other things, to modernize the banking industry's position in relationship to the securities and insurance industries, it does not eliminate all the barriers. Thank goodness for that. What we now see is the banking industry moving into the direct sales of insurance products produced by insurance companies. Everything from casualty insurance to life insurance is available or will be available from the local bank. The bankers will receive handsome commissions from the insurance companies for selling the products, but probably less than the insurance companies paid through an agents' system. The bank will create equally handsome incentive programs for the young Turks to sell these products to the bank's fiduciary customers, *always with adequate and full disclosure, of course.* Everybody wins - almost. Recently, I saw a memorandum from a bank trust counsel recommending to a trust administrator, that the bank as sole trustee of an irrevocable life insurance trust, consider buying a policy on the life of the insured grantor from its own agency! Self-dealing? Conflict of Interest? Duty of Loyalty to the trust? Does anyone believe this is an isolated case? Does anyone think things will get better before they get worse? Here we have it. The lawyer, guardian of trust law and principles, succumbing to the Siren's call for greater profitability.

What Happened to the Duty of Loyalty?

Many experienced staff of an acquired bank are either terminated or quit out of disgust over the changes being forced upon their fiduciary customers. Staff "duplication" is eliminated wherever the opportunity exists as the plunge to increase shareholder value becomes the mantra of the conquering managers. Functions such as the management of closely held businesses are consolidated in offices "with the most expertise," investment management of fiduciary assets is likewise moved, often more than once, to the so-called centers of expertise. Customers have no one to talk to locally when problems develop. If the 1-800 number doesn't solve the problem, customers have little recourse but to seek legal remedies. Unfortunately, even the regional banks have bought into this "consolidation" trap. What trust customers had come to expect as an at least acceptable level of service is thrown aside while departments are reorganized into selling machines, euphemistically called the "Private Bank/Wealth Management Group" to cross-sell to trust customers, bank products. Gone is the safety net of the Chinese Wall. Gone is the spirit of service and devotion to fiduciary principles. Trust administrators who had been the protectors of the fiduciary relationship are forced to sell their customers often unneeded and unsuitable services and products to meet quotas. Each quota unmet is one step closer to unemployment for these truly conscientious defenders of their customers. What choices do these workers have?

The time for change has arrived and not unexpectedly the banks have missed the landing. Statistics show that the market share of corporate trustees has been declining for many years. Customers have been fleeing sometimes from one bank to another, only to be caught in the next round of mergers, or to new brokerage operated trust companies who bring another set of problems and conflicts of interest with them. But the most affluent have tried to side step the fray by naming trusted individuals to handle their accounts. While this has proven to be a good short to near term solution, these same families are finding that the problem of continuity of management is not being satisfied. The result is the emergence of private trust companies structured to satisfy the service and investment needs of these families. Many of these new companies have divested themselves of the functions that create the self-dealing and conflict of interest problems now overwhelming the traditional corporate trustees who have lost their sense of both propriety and the law.

While some have been reading and understanding the intent of the Third Restatement of Trusts, Prudent Investor Rules, the proposed Uniform Trust Act, and studying the Trust Protector concept, the banking community continues to ignore the movement of the law and many former clients toward beneficiary rights and new means to avoid the problems discussed here. Those who are paying attention to customer needs versus making shareholder value prevail will, I believe, win the day and restore Trust to trust services.

Trust Investment Performance, Where Poor to Mediocre is the General Rule:

The Prudent Investors Act tells us to look at the total portfolio return versus the performance of either individual securities or income production. The supposed escape valve for the miniscule income return of equities is a provision of the Uniform Principal and Income Act which allows a trustee to allocate capital gains to income. Query, doesn't this scenario chase the idea that markets are always going to go up? Or, at least as "investment types" stress over the *long-term* markets have historically gone up? The problem is that many trust beneficiaries do not have a long-term existence before them. What about the beneficiary who is caught up in a "Short-term Correction" (maybe 3 -4 years) when any sale will be at a loss? What happens? Does the trustee realize loses to rebalance the portfolio? Can a remainder beneficiary demand a portion of the income to replace his capital losses?

It seems that the trust industry has thrown away good sense to conform to the investment side of the business, that Modern Portfolio Theory (MPT) advocates. The operable word here is theory because if it were fact, there would be many more fortunes made by investors. Trust portfolio managers generally follow the advise of either internal or external analysts. A recent report before Congress shows that the analysts make only one sell recommendation to every nine buy recommendations. Does this mean that 90% of their previous recommendations were correct? Hardly. Add to this, the matter of banks being a proponent of a particular investment style. Many bank trust departments tout their belief in sticking to a particular style no matter what, because "we're long-term investors and the market will turn around." This is little solace to beneficiaries or remaindermen. Yet, bank trust department managers will stick with a proposition that will cost their customers principal losses which will take years to recover. I would venture that at least weathermen change their forecasts when conditions change.

What Needs to Be Done?

Many serious problems lie in the path of correcting these growing abuses. One of them is us, the legal profession. In most large metropolitan areas, it is nearly impossible to find the first class law firm, that perhaps drafted the sophisticated and workable estate planning documents that are being impeded by the actions of a corporate trustee, that will sue the bank. The reason frequently given for such refusal is that the firm represents the bank and there is a conflict of interest. This can be read as, "The bank pays the firm very large fees every year and if we sue the bank that stream of income will no doubt disappear. What we'll earn from your case, even if we win, will never make up for such a loss." Of course, you can always go to Joe Newgraduate, class of this year, to handle your compliant.

Ideally, the attorney representing a harmed beneficiary, if he finds himself/herself in conflicted position will quickly inform the client of the problem and suggest hiring a competent attorney who can handle a case against a formidable adversary, the bank.

Lacking the ideal, trust beneficiaries should band together, through such groups as Heirs to pursue actions that will get a corporate trustee's attention -- large settlements or verdicts. Nothing says something like something that hits the bottom line. Communication and combining resources will be the way to subdue the self-dealing practices of profit obsessed banks. Writing Bar Committees, writing their state Legislator, writing their Federal Legislators, writing the Missouri Bankers Association, the cost is low but votes and profits are cherished.

The cure for mediocre performance and style paralysis is simple in theory, but difficult for a traditional bank trustee to implement. First, corporate fiduciaries should be held to common investment performance standards. If their performance falls below that of the market as a whole, say the S&P 500, and not some bogus benchmarks that banks frequently use to justify their sub-par performance, they should pay a price. If a bank cannot generally achieve that goal, it should be forced to seek outside managers who can meet the standard. In most cases, I would suspect that banks will be forced into index funds which by their nature, match the market. There is a side benefit to this result. The cost to operate an index fund is generally much lower than that to manage an active portfolio. The bank, mindful of its duty of loyalty, should naturally pass this savings onto the customer.

Second, corporate trustees, through public pressure, should be forced to change their method of compensation from the usual percentage of market value approach to a performance based system. For instance, banks do incur certain costs relative to the administration of trust accounts, e.g., accounting system expenses, tax preparation expenses, custody and transfer expenses and dealing with beneficiaries. They must be able to recover these costs and make a reasonable profit to stay in business. However, their greatest interest lies in management of assets because that is where the greatest profit lies. If we use a typical equity mutual fund as a proxy, we find that it may charge an annual asset based fee of say 1 % of the net asset value of the fund. Typically, about 30 basis points (0.30%) are attributable to items such as, custody of the underlying stocks, transfer agent fees, distribution (marketing) fees, legal and audit fees, directors fees, customer relations, etc. Presumably the individuals or entities providing these services are making a profit. That leaves 70 basis points (0.70%) for the management of the assets. Here, billions of dollars are made annually.

If we also assume that a trust department operates on pretty much the same cost distribution pattern as the mutual fund , and they do, why should a trust and ultimately the beneficiaries pay 70% of the fees for under performance? Practically speaking, because they currently have no other choice unless the trust instrument permits the beneficiaries or a Trust Protector to change the trustee. *[Missouri banks have successfully lobbied against granting trust beneficiaries the power to change corporate trustees without court action.]* The Grantor names the bank and everyone is stuck from that point forward with whatever philosophy the bank adopts regarding investment style and account administration. And remember, if the beneficiaries want to contest the actions of the trustee, the trustee can in most instances use trust assets to defend itself.

Conclusion:

A. If you are in the planning stages, remember that this is not the situation or time for the client to select a trustee based on price.

B. Find a corporate trustee that isn't married to either its own proprietary investment products or permanently linked to one investment style. There are corporate trustees who fit this criteria.

C. If your clients are stuck with an under-performing trustee or one who has lost sight of its fiduciary obligations, confront them, keep careful records of all conversations, contact a support group and as a last resort sue them. More and more attorneys are being drawn into the fiduciary litigation arena. You may be able to help.

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