RETHINKING TRUST SERVICES

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A White Paper for Community Bank Executives

Written by

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"When you start with an honest and diligent effort to determine the truth of your situation, the right decisions often become self-evident."

- *Jim Collins, Good to Great*

Introduction

There are approximately 1,400 bank trust departments in the United States - many of which are unprofitable and lack justification for the risks being assumed in their operation. With the current banking landscape of more lending competition, reduced net interest margins and increased employee costs, progressive community banks are now focusing their efforts on core business lines and reducing or eliminating non-core services – including trust.

Background

Community bank trust departments, in most cases, started out as a "courtesy" provided to the bank's customers. Over the past several years, community banks have placed more importance on the value of "non-interest" income; therefore, their trust operations have come under closer scrutiny for profitability (or lack thereof). Many community bank CEOs don't understand or realize the level of risk and potential legal liabilities that comes with operating a trust department. To make matters worse, the trust services provided often are not priced appropriately to accommodate for the risks taken. Industry-regarded institutional trust consultant Bob Fletcher has often stated, "Show me a community bank trust department and I will show you a ticking time bomb." Although bank regulators do not provide public information on trust legal issues, there are a number of cases where the beneficiaries have received significant jury awards; which have included actual and punitive damages.[1]

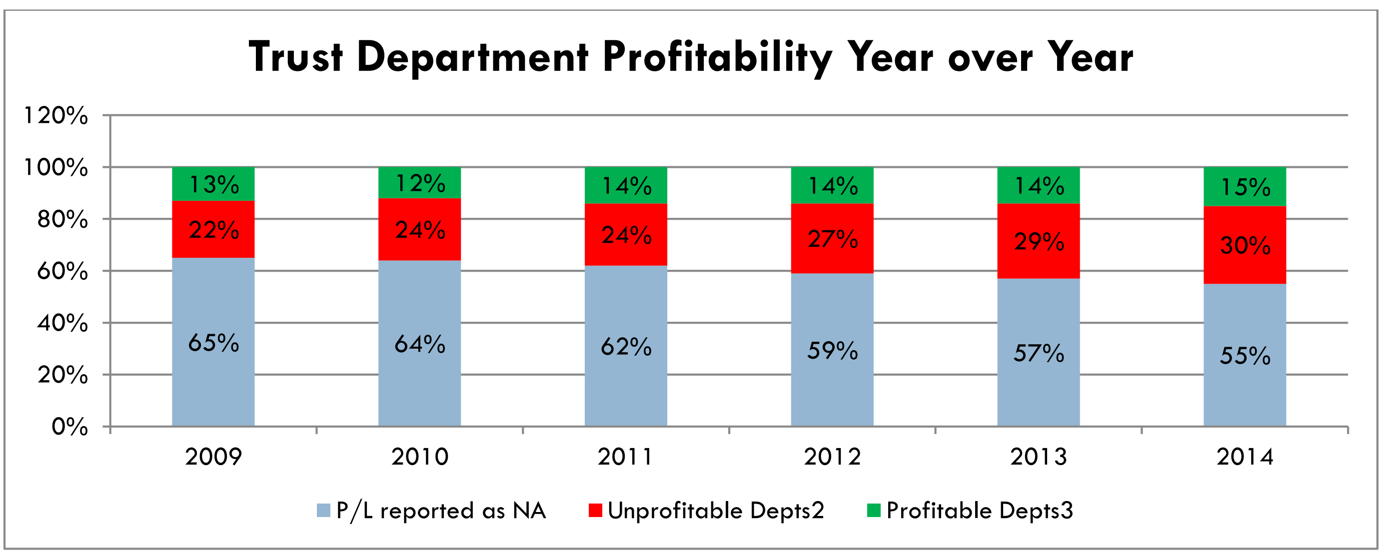
The FDIC acknowledges the trend in the trust industry by including language in its Examination Guidelines:

In recent years financial institutions have become increasingly aware of, and focused on, the contribution of noninterest income to profitability. Recurring fee income can enhance profitability, and it is often less volatile than interest income. Trust department income can be an important component of noninterest income. [However] not every trust department is profitable and many small trust departments are operated primarily as a community service. Trust services are also offered in order to retain more profitable relationships elsewhere in the bank.

Although various reasons for offering trust services exist, the FDIC expects each bank operating a trust department to be aware of the department's contribution, or cost, to the operating earnings of the bank. Banks operating trust departments should regularly measure and evaluate the impact of both direct and indirect trust income and expenses on their overall profitability. Some form of accounting system should be implemented to provide the basis for an analysis of the department's income and expense data. Management may use those results to determine which services should be continued or discontinued, whether fees should be adjusted, and which types of accounts should be emphasized in new business development efforts.[2]

Profitability

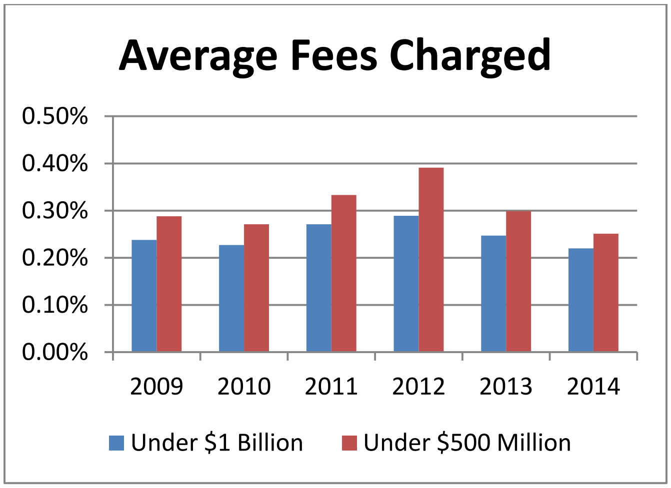
The chart below shows those trust departments that report actual profits or losses; unfortunately, over half report "N/A" rather than a number. Of those that report "N/A," approximately two-thirds have trust revenue of less than $100,000, which would suggest these trust operations are not profitable.[3]

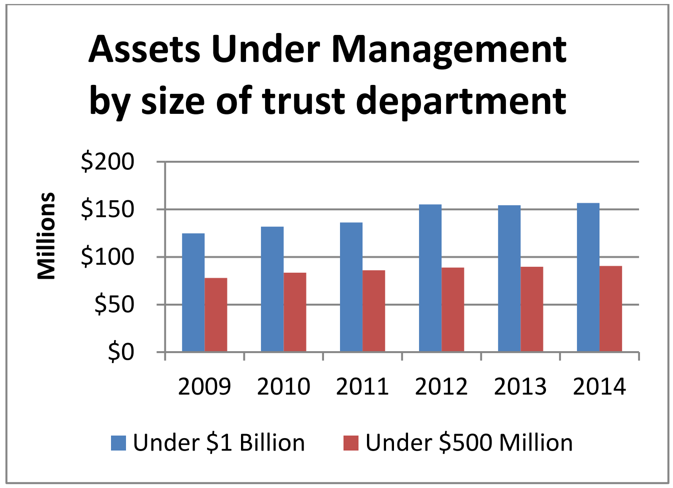


SNL Database

Key Trends:

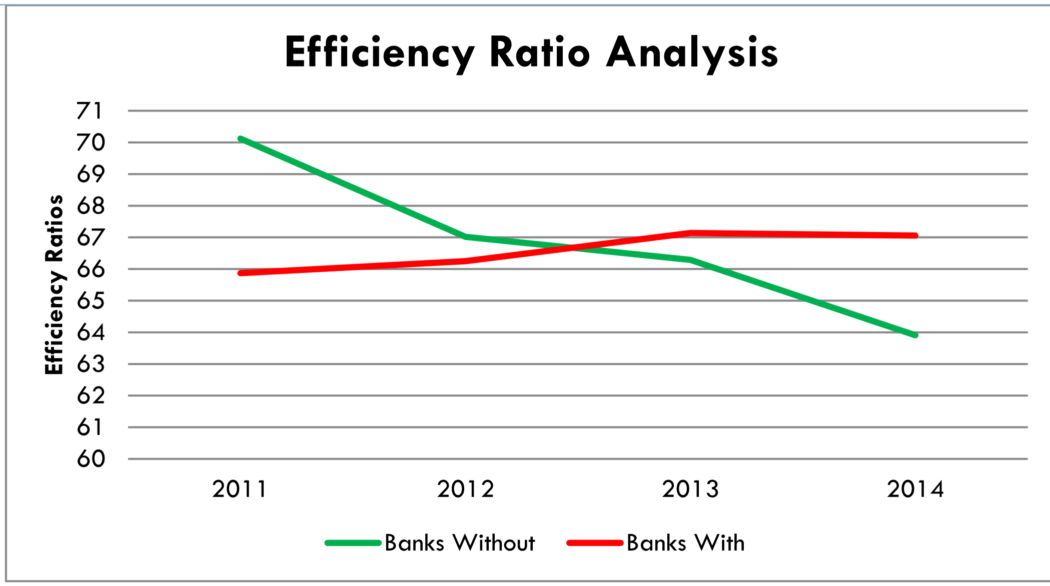
- The percentage of unprofitable trust departments has risen from 22% to 30% since 2009 - an increase of over 36%
- 85% of US bank trust departments are either unprofitable or marginally profitable





Based on SNL data, trust departments with "under $1 billion" in assets under management (AUM) charge, on average, less than those trust departments with "under $500 million" AUM. In fact, growing AUM is a daunting task as only 33 trust departments were able to grow to over $1 billion in assets from 2009 to 2014. Of those 33, only eleven trust departments grew from under $500 million in assets to over $1 billion. Even if a trust department decides to grow their AUM, it still may not be enough to become profitable.

Trust operations affect a bank's efficiency ratio. A trend emerges when analyzing bank's efficiency ratios between those that still have trust departments and those which no longer have trust departments.



On average, the efficiency ratio improved approximately 9% (from 70.12 down to 63.91) for those banks that made the tough choice to exit the trust business. The banks which have kept their trust departments have seen, on average, their efficiency ratios trending higher (from 65.74 to 67.14).

Risks

Risks involved in the operation of a wholly-owned trust / wealth management department include but are not limited to the following:

- Business
- Regulatory
- Legal
- Fiduciary
- Reputation

The legal risk associated with trust operations is typically underestimated by bank executives. In today's litigious environment, with fiduciary rules tightening and compliance demands increasing, multi-million dollar combinations of settlements and legal costs are very real risks for community bank fiduciaries. Furthermore, with equity markets at all-time highs, the possibility for muted or negative investment returns in the future could exacerbate the aforementioned risks. Lastly, unwanted publicity associated with claims and lawsuits which could tarnish the bank's reputation within the community could cost the bank more than actual complaint and legal costs.

All business operations include a risk component; however, increased risk to the institution coupled from trust operations with low or no profitability does not add up to a positive long-term financial outlook for any institution.

Solutions

So, what should a community bank do about their trust department?

Options:

1) Improve Trust Profitability – hard to accomplish, but certainly a strategic option, especially over $500 million AUM. Usually requires a complete HR and cost overhaul.
2) Close the trust department – consider HR and trust “relocation” issues. Also loss of customer wallet share.
3) Outsource the trust department to a firm that specializes in fiduciary management in a revenue sharing arrangement. New provider would assume liability and costs. Requires ample due diligence on provider. Also regulations differ from state to state.

Conclusion

Bank executives and boards of directors have a duty to understand and monitor the risks created by their trust operations. They also must weigh those risks to determine if those trust operations are still a viable and vital part of the bank. Community banks, just like any business, cannot, and should not, continue to subsidize unprofitable divisions within their organization. Therefore, the prudent decision is to determine the best course of action when dealing with an unprofitable trust operation – and move decisively in terms of execution.

Works Cited

[1]Barbara Burton Morriss v. Wells Fargo NA et al., case number 12SL-PR03035 St. Louis County Circuit Court, Missouri; Fifth Third Bank & Elizabeth Gamble Reagan v. Firstar Bank, N.A., 2006-Ohio-4506

[2]FDIC Trust Examination Manual – Section 9A

[3]SNL database – Screening for Fiduciary Activity Reported, NII: Fiduciary Activities, and Net Losses from Fiduciary Services

ABOUT THE AUTHOR

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Over the years, Dr. Ed Seifried has touched the hearts and minds of almost every director and CEO of community banks across the nation. While recognized for his keynote speeches, Dr. Ed is a valued educator for community bank directors, CEOs, senior management, and up and coming community bankers.

Carrying on his tenure as Professor Emeritus of Economics and Business at Lafayette College, Dr. Ed has led the educational programs as Dean for the West Virginia Banking School and the Virginia School of Banking. He has been on the faculty of many banking schools, including Stonier and the Graduate School of Banking at LSU.

Most recently, Dr. Ed is the Executive Director of the Sheshunoff Affiliation Program. This highly acclaimed program provides high performance education and idea exchanges for community bank CEOs, Lenders, and Technology/Operations Officers.

Having served as a community bank director, Dr. Ed believes that one has to experience the dynamics of being a community bank director to fully understand their needs to create the bank's strategic plan, assess risk, set risk parameters, monitor risk, and to be thoroughly educated.