The Functions and Investment Policies of Personal Trust Departments—Part II

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PERSONAL TRUST DEPARTMENT EARNINGS

The first instalment of this article observed that the personal trust departments of small banks render services primarily to individuals, with these services limited usually to personal trust accounts and estate accounts. It is mainly the large banks that offer the more comprehensive variety of fiduciary services, including employee benefit trust fund accounts as well as personal agency and employee benefit agency accounts.

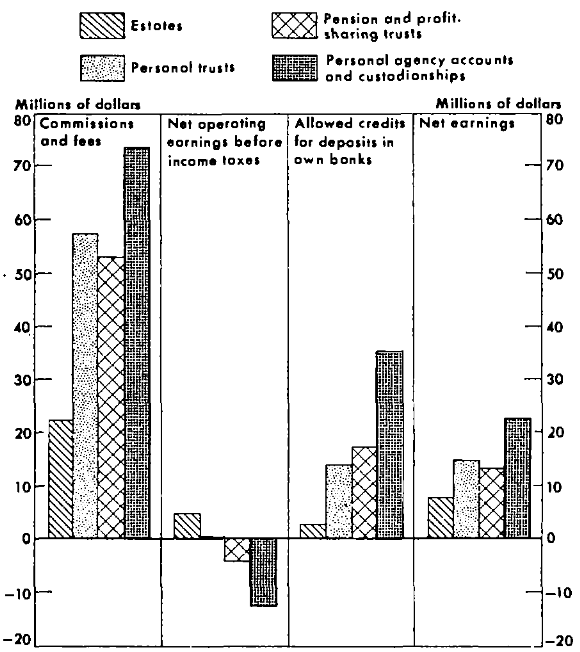
In 1971, the ten largest personal trust departments in New York City earned revenues from commissions and fees totaling $206 million, up from $186 million the year before. Operating costs also rose, but by a smaller amount, leaving a net operating deficit (before taxes) of $11 million, 13½ percent less than the 1970 deficit. The banks, however, allow sizable credits to their trust departments for funds they deposit in the banks. Such credits totaled $69 million in 1971, resulting in net earnings by the ten trust departments of $58 million. Measured against the aggregate of commissions and fees plus allowed deposit credits, these net earnings constituted an average return of 21 percent. In 1970, when prevailing interest rates had been higher, allowed deposit credits had totaled $92 million, considerably more than in 1971; as a consequence, the average return had also been much higher, namely, 28 percent.[22]

The funds deposited by trust departments in their own banks represent primarily cash balances from estates, pending either payment of debts and claims or distribution to designated parties; from trust accounts, pending investment of principal or distribution of income; and from agency accounts, pending receipt of instructions from the principals. In addition, at certain times, deposits accumulated from trust and agency accounts pending presentation of securities by brokers have risen to a level higher than usual because of so-called securities delivery "fails", such as were widespread during 1969 and 1970 because of the inability of back offices of many brokerage houses to cope with a greatly increased volume of stock market transactions. At many banks, the trust department deposits are larger than those of the bank's biggest outside depositor. The credits allowed to trust

[22] In 1971, one of the ten banks did not supply data for allowed credits. Allowed credits for that bank were arrived at by "applying an average of the rates of credit used by nine banks to the average undistributed and uninvested cash balances" of the tenth bank. Federal Reserve Bank of New York, *Survey of Earnings and Expenses of Trust Departments in New York, New Jersey, and Fairfield County, Connecticut* (1970 and 1971).

Chart XIII

EARNINGS OF TEN LARGEST NEW YORK CITY PERSONAL TRUST DEPARTMENTS, 1971



Source: Federal Reserve Bank of New York, *Survey of Earnings and Expenses of Trust Departments in New York, New Jersey, and Fairfield County, Connecticut in 1971*.

departments for these deposits reflect the profit derived from employment of the funds in commercial banking operations.[23] The rate at which credit is allowed is computed differently from bank to bank. In 1971 the rate averaged 5.67 percent for the ten biggest New York City trust departments, compared with 7.86 percent the year before. This was the first time in ten years the average rate had fallen.

Fully half of the 1971 credit allowed to personal trust departments at the ten New York banks was for deposits from personal agency accounts and custodianships. As a result, even though there had been a sizable operating loss in connection with these accounts, they yielded the largest volume of net earnings (see Chart XIII). Measured against the total of current revenues and allowed deposit credits, the yield amounted to 21 percent. Personal trust accounts, which showed a very small operating profit, produced the second biggest volume of net earnings, with the same percentage yield as for the personal agency accounts and custodianships. The volume of net earnings from employee benefit trust accounts ranked a close third, despite a modest operating loss, and resulted in a yield of 19 percent. Moreover, the rate of rise in employee benefit trust account net earnings has been much more rapid than for any other category of accounts. Between 1963 (the first year for which the relevant data are available) and 1971, the dollar increase was approximately the same as that from personal agency accounts and custodianships, \$6.5 million as compared with \$6.4 million, but the first figure represented a 98 percent growth while the second amounted to a gain of only 40 percent.

The fee structure for each type of account is importantly influenced by account size, with the largest accounts having far lower rates than those at the other end of the scale. Reflecting the predominance among employee benefit trust accounts of large size trusts, as well as the especially vigorous competition for such accounts, the average fee for managing employee benefit trust accounts is considerably lower than that for other types of accounts. A special survey of fifty banks made for the Securities and Exchange Commission (SEC) showed that in 1969 the average fee rate charged for employee benefit accounts was 0.10 percent, measured as a percentage of assets, whereas the average fee rate for personal agency accounts was 0.20 percent and that for personal trust and estate accounts 0.35 percent.[24] The 1971 revenues from commissions and fees received by the ten largest New York City trust departments, taken as a percentage of the average of assets held in late 1970 and 1971,[25] similarly pointed to a much lower average fee rate for employee

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[23] In an address to the trust divisions of the California and Texas bankers associations, Reese Harris, retired executive vice president of Manufacturers Hanover Trust Company, commented: "One of the most important reasons for a bank to have a trust department is to benefit by its inevitable cash balance." *American Banker* (July 3, 1972).

[24] *Institutional Investor Study Report of the Securities and Exchange Commission,* Volume 2 (March 10, 1971).

[25] Federal Reserve Bank of New York, *Survey of Earnings and Expenses of Trust Departments,* and the annual reports prepared jointly by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, *Trust Assets of Insured Commercial Banks* (1970 and 1971). The data in the trust asset surveys do not all refer to identical dates. In the 1971 survey, it is noted that: ". . . asset valuation dates differ somewhat among reporting trust departments. However, one can assume that the bulk of trust assets were valued or reviewed during the second half of the year, with an emphasis on the month of December." The previous survey contained a similar note.

benefit trust accounts than for other types of accounts. These calculations indicated for personal trust and estate accounts, for example, a fee rate of 0.31 percent, but for employee benefit trust accounts a fee rate of only 0.11 percent.

The relatively high fees on estate accounts, combined with the comparatively low cost of administering the liquidation of most estates, resulted in a greater volume of net operating earnings from these accounts for the ten large New York City banks in 1971, as Chart XIII shows, than from any other group of accounts.[26] However, because of the comparatively small dollar total of estate accounts, the gross revenues they generated were less than those for other accounts. This was also the case regarding the credits allowed on estate account deposits. Consequently, the volume of earnings from this category of accounts after adding in the allowed credits was also less than from any of the other categories. Still, the yield was 31 percent, higher than for any other category.

The aggregate commissions and fees earned in 1971 by personal trust and corporate trust departments (the latter departments have not been discussed in these articles) at the nine largest New York City banks constituted 7.7 percent of the banks' aggregate current operating revenues, up from 6.5 percent the previous year. It is estimated that somewhat more than half of these trust department revenues represented the commissions and fees earned by the personal trust departments alone.[27]

Many banks across the nation, in addition to allowing credits for trust department deposits, also provide explicit recognition of other benefits derived from the operation of personal trust departments: some banks allow credit for loan and deposit relationships developed by the bank with trust department customers, for services performed for the bank by the trust department, for unprofitable trust accounts kept by the department for various reasons for customers of the bank, and for investments that the department makes in certificates of deposit issued by the bank. At the larger banks in the Second Federal Reserve District, these credits reportedly are calculated separately and are not part of the credits allowed for deposits; they are generally applied as a partial offset to current operating expenses, and thus affect the net operating earnings figures. Procedures vary, however, from one Federal Reserve District to another.

Also of interest to banks are the deposits of those stockbrokers who receive commissions for carrying out the securities transactions of the trust departments. The earlier noted SEC survey of fifty banks showed that in 1969 such stockbroker deposits comprised a significant sum. The authors of the survey found the available information suggested that the larger portion of this sum comprised deposits intended as a compensation for banking services, such as handling checks and deposits, while close to half of the total was deposited by the brokers in an effort to attract trust department business.[28]

The smaller the trust department, the less profitable it usually is. In 1971, among the banks covered by a Federal Reserve System nationwide survey that excludes the large New York City banks referred to earlier, the 25 percent top earners among trust departments with more than $1 million in average annual commissions and fees during the five years 1967-71 had net operating earnings equal to 19 percent of current revenues. The corresponding figure for the top earners in the $500,000 to $1 million group was only 16 percent, and for those in the $100,000 to $500,000 group it was only 8 percent.[29] Apparently, most of the top earners in departments with even smaller revenues actually had net operating deficits. Indeed, most small trust departments have net operating deficits, year in and year out, that are not offset by allowed credits on deposits.[30] During the five years from 1967 through 1971, commissions and fees earned by trust departments at banks with deposits of less than $50 million have

[26] In New York State, the statutory ceilings on rates charged for administering estates and testamentary trusts were raised in September 1969 for the first time in fourteen years.

[27] The information regarding the aggregate revenues is from the Federal Reserve Bank of New York publication *1971 Operating Ratios of Second District Member Banks.* The estimate regarding the personal trust department revenues alone is based on the more detailed information in the earlier cited Federal Reserve Bank of New York *Survey of Earnings and Expenses of Trust Departments.*

[28] *Institutional Investor Study Report of the Securities and Exchange Commission,* Volume 2.

[29] From *Performance Characteristics of High Earning Banks, Functional Cost Analysis—1971* (Based on Data Furnished by Participating Banks in Twelve Federal Reserve Districts). The top 25 percent of earners with more than $1 million in average annual five-year income numbered eight; those in the next group twelve; and those in the lowest group forty-one.

[30] No nationwide data are available regarding allowed credits, but in the Second Federal Reserve District the 1971 average rate of allowed credit for 109 small- and medium-size trust departments was 5.67 percent, identical to the rate reported by the ten largest New York City departments. Data available for only 76 banks in the District show these banks allowed their combined corporate and personal trust departments deposit credits totaling $16 million. This converted net operating losses into net earnings totaling $14 million.

amounted, on average, to only 71 percent of department expenses.[31] In some cases, these operating deficits may be inevitable since most of the accounts are small. Such accounts take relatively more time to handle than large accounts.

A large proportion of the smaller banks apparently believe it is appropriate to provide fiduciary services despite net operating losses that are not offset by credits allowed their trust departments. (It should be noted, moreover, that many of the smaller banks—perhaps the majority—do not follow the practice of calculating and allowing credits to the trust departments.) Those who manage small banks have advanced several arguments for continuing these operations despite the operating losses, among them the following. A trust department can perform services for its bank; these include the administering of the bank's own employee trust funds, the handling of own bank stock transfers, and the disbursing of dividends on stock of the bank. Fiduciary activities constitute a service to the community; effective performance of such a service adds to the prestige of a bank. If a bank does not provide trust services, in time it will lose commercial banking business to banks that do. Finally, trust department customers, out of convenience, often become commercial bank customers.

Table III
PERSONAL TRUST DEPARTMENT HOLDINGS OF SELECTED FINANCIAL ASSETS

Type of asset	Trust department holdings*		Holdings as a share of outstandings	
	1968	1971	1968	1971
	Billions of dollars		Percent	
Stocks†	187.8	230.9	19.1	22.4
State, county, and municipal securities	18.2	19.5	14.7	11.7
United States Government and agency securities‡	15.7	17.2	6.1	5.8
Other bonds§	38.5	46.4	22.9	20.0
Mortgages	6.4	6.5	1.6	1.3

* Market values.
† Common and preferred stocks; common stockholdings of the trust departments in 1968 and 1971 amounted to $182.8 billion and $223.9 billion, respectively.
‡ Outstandings exclude holdings by the Federal Reserve System, United States Government accounts, and credit agencies sponsored by the United States Government.
§ Mainly corporate bonds, but includes also some foreign and international agency bonds.
Sources: *Trust Assets of Insured Commercial Banks* (1968 and 1971) and "Flow of Funds", *Federal Reserve Bulletin* (June 1972).

RAMIFICATIONS OF TRUST DEPARTMENT ACTIVITIES

The sheer size of financial assets held by the commercial banks as fiduciaries has awakened strong public interest, and even fears, regarding the additional economic and financial power that might accrue to the banks as a result of their role as large fiduciary investors. Concern has been expressed, too, about the potential for conflicts of interest.

There are other ramifications of trust department operations that have not stimulated the same interest but are worthy of attention nonetheless. For example, certain categories of commercial banks' fiduciary assets are impressive not only in absolute dollar terms but also as percentages of the total of such securities outstanding. This is particularly striking with regard to equities and corporate bonds, with the trust departments accounting in 1971 for 22.4 percent and 20.0 percent, respectively, of the outstanding totals. The share of local government securities held was also noteworthy (see Table III). It is therefore conceivable that the banks' fiduciary investment activities could have substantial implications for the markets in these securities. Only one of the numerous topics that could be discussed within the context of this broad issue will be considered in this article, and that only briefly.

INFLUENCE ON EQUITIES MARKETS. Trust departments held $224 billion of common stocks in 1971, a much greater volume than any other type of institutional investor. These fiduciary assets were more than four times the value of stocks held by mutual funds (see Table IV). The bank holdings accounted, moreover, for 21.7 percent of total stocks outstanding (common and preferred),[32] compared

[31] See *Functional Cost Analysis, 1971, Average Banks* (Based on Data Furnished by 994 Participating Banks in Twelve Federal Reserve Districts), and parallel earlier surveys. The number of banks covered by the survey in the size classification mentioned declined from 769 in 1967 to 334 in 1971, mainly owing to mergers.

[32] The total market value of outstanding stocks is available only as an aggregate of both common and preferred stocks. Trust department holdings of both types constituted 22.4 percent of the total outstanding, as shown in Table III. Preferred stocks outstanding are only a small portion of total stocks.

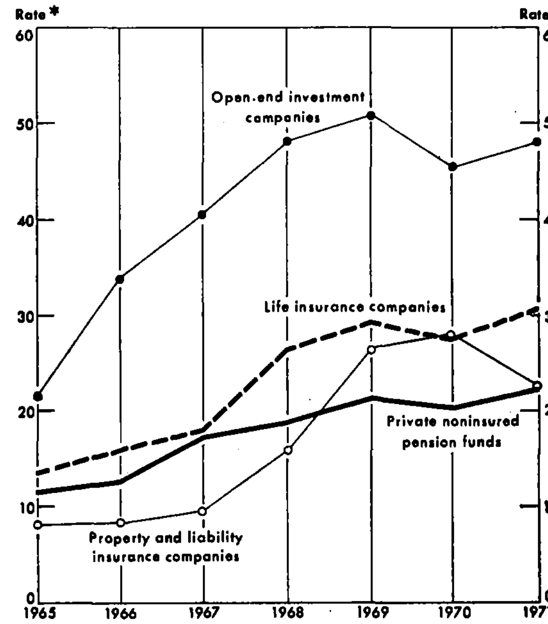
with the 8.0 percent held by other major institutional groups combined, namely, the mutual funds, the life insurance companies (including separate accounts), and the property and liability insurance companies. The prominent position of the banks reflects primarily the steep rise since the early 1950's in pension plan trust funds and the rapid shifts in the various fiduciary accounts in recent years from fixed-income investments to common stocks.

Since the mid-1960's, there has also been a sharp step-up in the pace at which these stockholdings have been turned over. As the trading activity rates on Chart XIV indicate, the purchases and sales of stocks by *all* private noninsured pension funds (i.e., funds administered by trust departments as well as funds administered by others) relative to the total stockholdings of these funds nearly doubled in the six years from 1965 through 1971, reflecting the effort to improve performance by seeking opportunities for capital appreciation. Since the major portion of these pension funds is administered by trust departments, a change in the activity rate for total private noninsured pension funds can be regarded as a rough guide to the direction of movement in the pension fund account activity rate of banks as a group, although the actual levels of the two sets of activity rates may differ. Trading activity varies greatly, of course, as between large and small banks, but the big banks hold the vast bulk of pension plan fund assets (in 1971, 86 percent of the employee benefit trust fund assets at banks was lodged at the fifty-nine banks with trust assets of more than $1 billion each), and activity rates of such banks have been much higher than the rates for total private noninsured pension funds.

Detailed data on big bank trading activity are limited to the years 1965 through 1969 and cover the transactions of the fifty large trust departments surveyed in 1970 for the SEC's institutional investor study. As can be seen on Chart XV, there was a very rapid step-up between 1965 and 1969 in turnover by the large banks of the equities held for employee benefit trust funds, with the activity rate for the most numerous size group of employee benefit trust funds rising from 14 percent to 32 percent. (The

Chart XIV

COMMON STOCK ACTIVITY RATES OF SELECTED INVESTOR GROUPS



* Activity rate is the average of purchases and sales divided by the average market value of stockholdings, stated as an annual rate.

Source: Securities and Exchange Commission, "Stock Transactions of Financial Institutions in 1971", Statistical Series, Release No. 2582.

Table IV

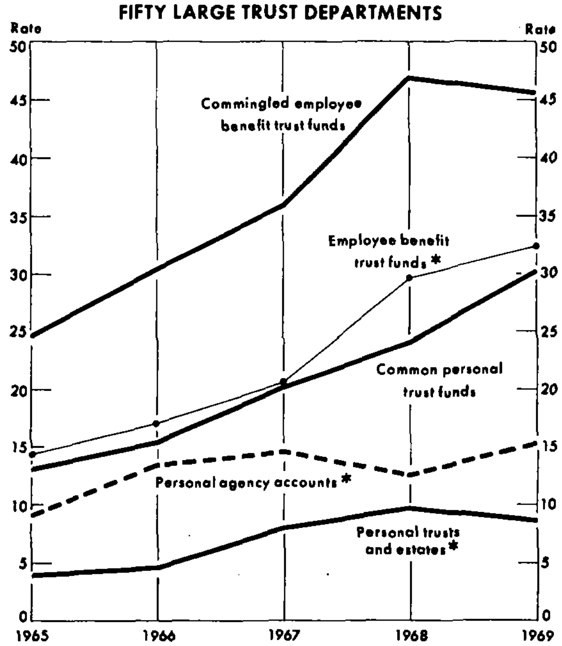
COMMON STOCKHOLDINGS AND STOCK TRANSACTIONS OF SELECTED INVESTOR GROUPS

Investor	Stockholdings		First half 1971 stock transactions as a share of total institutional transactions*	
	1970	1971	New York Stock Exchange	Other markets†
	Billions of dollars		Percent	
Personal trust departments, total	179.5	223.9	38.5	29.5
Personal trust and estate and personal agency accounts	118.5	142.1	‡	‡
Employee benefit trust and agency accounts	61.0	81.8	‡	‡
Open-end investment companies	42.6	51.2	21.7	17.9
Life insurance companies§	11.9	16.8	3.3	2.2
Property and liability insurance companies	11.7	14.2¶	2.5	1.7
Private noninsured pension funds#	65.5	84.8	‡	‡

* Transactions measured in terms of number of stocks.
† Transactions by New York Stock Exchange members executed on all other United States exchanges and in the over-the-counter market.
‡ Not available.
§ Includes special accounts.
\# The bulk of these pension fund holdings is included in the figures shown above for employee benefit trust and agency accounts in bank trust departments. The bank figures also include, however, profit-sharing funds and other types of employee benefit funds.
¶ Preliminary.
Sources: *Trust Assets of Insured Commercial Banks* (1970 and 1971); New York Stock Exchange, *1971 Public Transaction Study;* and Securities and Exchange Commission.

Chart XV

COMMON STOCK ACTIVITY RATES AT FIFTY LARGE TRUST DEPARTMENTS



* Activity rate for the size category with largest number of accounts.

Source: Institutional Investor Study Report of the Securities and Exchange Commission (1971).

increase in the activity rate for the relatively few funds with assets of more than $50 million each was substantially less; for these, turnover rose from 14 percent to 23 percent.) As a consequence, by 1969 the activity rate was more than half again as high as that for all private noninsured pension funds (see Chart XIV). Similarly, the activity rate for the commingled employee benefit trust funds at these large banks, which had increased from 25 percent to 46 percent, was more than double that for all private noninsured pension funds and not far below the activity rate (51 percent) for mutual funds. It is also noteworthy that the gap between the widely publicized activity rate of the mutual funds and that of the fifty large banks for their employee benefit trust funds (as well as that for their common personal trust funds) more or less stabilized between 1967 and 1969. Comparison of the subsequent activity rate data for mutual funds and those for all private noninsured pension funds suggests, moreover, the gap may actually have narrowed somewhat in the more recent years.

The increases during the 1960's in bank activity rates, in combination with the continuing inflow (despite the growing competition from other types of money managers) of new fiduciary funds, resulted in banks maintaining their position into the seventies as far and away the principal public traders in the equities markets.[33] During the first half of 1971 (the last period for which information is available), banks accounted for 38.5 percent of the share volume on the New York Stock Exchange attributable to institutions, while mutual funds were a distant second with 21.7 percent; the banks were also the major institutional traders on other markets (see Table IV). The banks' share of institutional trading on the New York Stock Exchange was slightly higher than it had been in 1969 (the last previous survey year) but somewhat less than the 40.6 percent attained in 1960. However, the overall role of institutions in the market has expanded tremendously since the early sixties. In 1961, institutions had accounted for only one third of all the public trading on the New York Stock Exchange, and individuals for two thirds. By 1971, the participation rates were almost completely reversed, with institutions responsible for 60 percent and individuals for only 40 percent.[34] Thus, the banks now account for virtually one fourth of total public volume (which has remained at slightly over three quarters of total equities transactions since 1961). It is anticipated, moreover, that the banks' share will grow further during the remainder of the seventies, despite a probable slowdown in the rate of inflow of new pension money.[35]

The great importance of the banks in the equities markets raises several questions. For example: Do the trading activities of banks, whose transactions often involve very large amounts of a given stock, have significant effects on stock prices? An intensive SEC study done on the basis of a sampling of institutional trading during the period January 1968 through September 1969 found that a stock position change by trust departments, like that by mutual funds, "sometimes does have a significant price impact" but that "situations in which the trading of an institution may create or accentuate price movements are more or

[33] "Public" trading refers to all trading on the stock exchanges except that done by member brokers and dealers for their own account.

[34] The New York Stock Exchange, *1971 Public Transaction Study*.

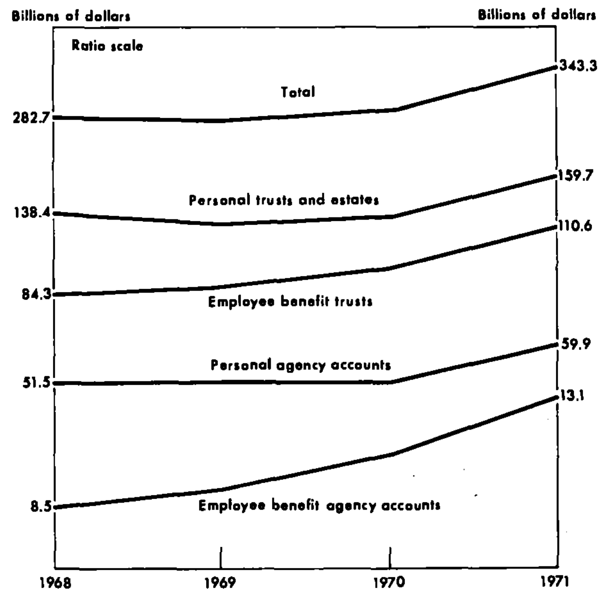
[35] New York Stock Exchange projections show banks accounting for 42.5 percent of the institutional share volume in 1980, compared with the 38.5 percent recorded for the first half of 1971. The Exchange also projects a substantial growth in the total institutional role, from 59.7 percent of public share volume to 72.0 percent. New York Stock Exchange, "Institutional Activity on NYSE: 1975 and 1980", *Perspectives on Planning* (June 1972).

less matched in number and importance by situations in which the trading behavior of an institution reduces the magnitude of the price impacts of trading by others". The study also found that the managers of mutual funds "tend to be price aggressive"—that is, they tend to buy more than they sell when prices are going up, and to sell more than they buy when prices are going down. Thus, "their net trading imbalances tend to contribute to price changes in the same direction. Banks, on the other hand, tend to be price neutral: Their net trading imbalances tend to be in the opposite direction to the price change as frequently as they are in the same direction. In the former situation they trade passively in response to the price change. . . ."[36]

There seems reason to be dubious about the applicability to the current situation of these findings for 1968-69. In the three to four years that have since elapsed, banks have been more eager to show performance. This is exemplified by the search for stocks with prospects for a rate of growth that would outperform the popular stock market averages.[37] The banks' reduced reliance on blue chips and their increased interest in somewhat riskier stocks may imply they now are more "price aggressive" and trade less "passively" than in the period covered by the SEC study. If this is actually the case, the banks may be contributing somewhat more to price changes than they did during 1968-69.

Chart XVI

GROWTH OF PERSONAL TRUST DEPARTMENT ASSETS



Note: Data based on market values.
Source: Trust Assets of Insured Commercial Banks (1970 and 1971).

* * *

SUPPLEMENTAL NOTE

Trust Assets of Insured Commercial Banks—1971, the fourth annual joint survey by the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, appeared in print subsequent to publication in this Bank's October 1972 *Monthly Review* of the first part of "The Functions and Investment Policies of Personal Trust Departments". The second instalment of this article has made use of the new survey, and this supplemental note updates some of the developments discussed in the first instalment.

Assets held by personal trust departments rose much more rapidly in 1971 than in the prior two years,[38] measured in market value terms. An increase of 17.5 percent ($51 billion) brought the total to $343 billion (see Chart XVI). In the "Explanatory Notes" that accompany the published data, it is suggested that roughly 70 percent of the growth reflected appreciation of asset values and only about 30 percent net inflow. This would imply that the actual net inflow was no larger, and might even have been somewhat smaller, than in either of the two previous years. It is possible, however, that more refined estimates of the changes in asset values would result in modification of this conclusion.

The biggest 1971 dollar gain, $23 billion, was in per-

[36] *Institutional Investor Study Report of the Securities and Exchange Commission,* Volume 4.

[37] An analysis of stocks held at the beginning of 1972 by 494 common trust funds is revealing. This analysis showed that: seventeen of the twenty-five stocks most favored by these funds a year earlier had lost considerable ground in terms of the number of funds holding them; over one third of the 1,278 stocks in the 494 portfolios were not held by more than one fund; and fully one fourth of the stocks had not appeared in any of the portfolios a year earlier. See *Trusts and Estates:* "Common Trust Fund Annual Survey" (May 1971) and "23rd Annual Survey of Common Trust Funds" (May 1972).

[38] As was indicated in footnote 25, the annual survey data apply to varying dates, with December data the most prominent.

Table V

PRINCIPAL COMPONENTS OF PERSONAL TRUST DEPARTMENT ACCOUNTS

Percent of portfolio

Type of account	Common stocks	Corporate bonds	United States Government and agency securities	State, local, and municipal securities
Personal trusts and estates:				
1970	64.4	6.9	7.1	8.8
1971	65.7	7.4	5.5	8.8
Employee benefit trusts:				
1970	61.3	24.7	4.4	0.1
1971	67.7	20.2	3.5	0.1
Personal agency accounts:				
1970	60.9	14.3	7.7	9.1
1971	62.1	13.8	6.7	8.9
Employee benefit agency accounts:				
1970	49.2	32.1	5.5	0.4
1971	53.1	29.6	4.6	0.5

Note: No breakdown is available on the composition of the $3.7 billion of assets held in 1970 accounts at Old Colony Trust, now merged with The First National Bank of Boston. It is clear, however, that the inclusion of these assets would modify the 1970 percentages only negligibly.

Source: *Trust Assets of Insured Commercial Banks* (1970 and 1971).

sonal trusts and estates, but employee benefit trusts, which rose by $18 billion, had a greater percentage gain (19 percent as against 16 percent), continuing the growth relationship that has obtained between these two principal categories of accounts since at least the early sixties. Agency accounts, both personal and employee benefit, also recorded sizable percentage increases, but the dollar increments were relatively small.

The changes in asset composition of the various types of accounts are shown in Table V. In 1971, common stockholdings comprised a greater proportion of all categories of accounts than they had in 1970; the advance was especially strong for employee benefit trusts. Of course, part of this pervasive growth reflected the rise in stock prices between 1970 and 1971. The other principal portfolio components generally showed percentage declines, although for most of these components the dollar totals in aggregate trust department portfolios rose. Only for Government and agency securities was an actual dollar decrease reported. This decline, which amounted to $1 billion, occurred despite a substantial advance in prices.