



STRATEGIC INITIATIVES

Fiduciary Hot Topics

The Good, The Bad, and The Ugly!

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by

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Introduction



Purpose

- Present general observations regarding the industry.
- Discuss challenges facing the fiduciary industry.
- Outline various trends impacting the industry.
- Provide an overview of opportunities available to the industry.
- Discuss the role of Compliance, Risk Management, and Audit
- Provide for an interactive and fun session!



Objective

Discuss various items that have an impact on the Asset Management and Fiduciary industry and how these items can be Good, Bad, and Ugly!!

The Wind Up



Risk / Reward

Alberto Salazar: *If you want to achieve a high goal, you're going to have to take some chances.*

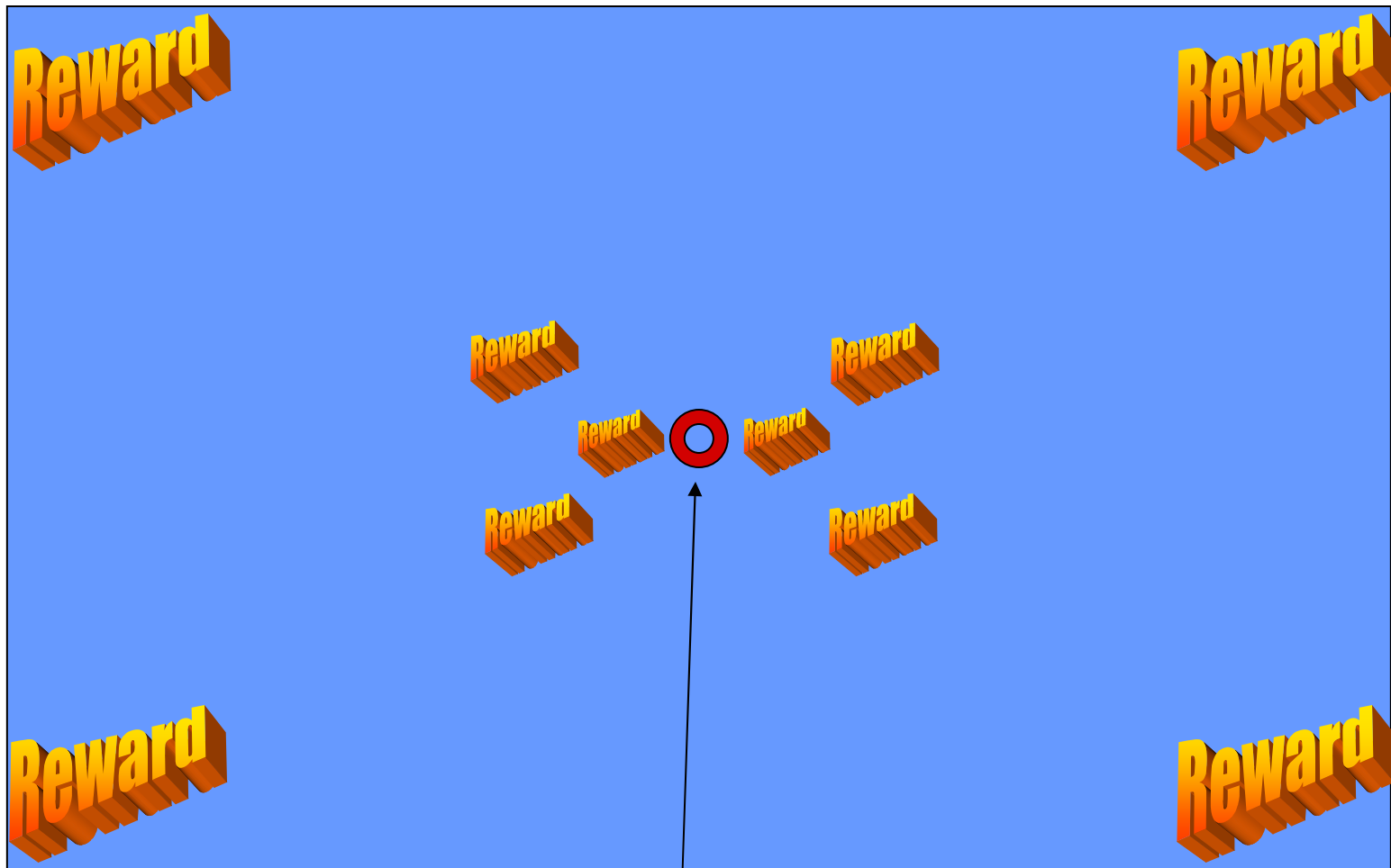
John F. Kennedy: *There are risks and costs to a program of action. But they are far less than the long-range risks and costs of comfortable inaction.*

Trammell Crow: *There is as much risk in doing nothing as in doing something.*

Ayn Rand: *To achieve, you need thought. You have to know what you are doing and that's real power.*

Author unknown: *Only those who do nothing make no mistakes.*

... The Pitch



Industry Overview

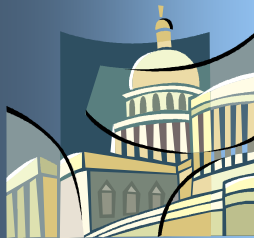
Competition



Highly Competitive:

- Banks
- Trust Companies
- Mutual Funds
- Insurance Companies
- Brokerage Firms
- Financial Planners
- CPA's
- Attorneys
- Internal Sources

Regulation



Highly Regulated:

- OCC
- FDIC
- Federal Reserve
- OTS
- DOL
- IRS
- SEC
- NASD
- State Laws
- FASB
- Litigation

Technology



Technology Dependent:

- Limited Providers
- Limited Support
- Outdated
- Knowledge
- Expertise
- Resources
- Conversions
- Contracts

Revenue

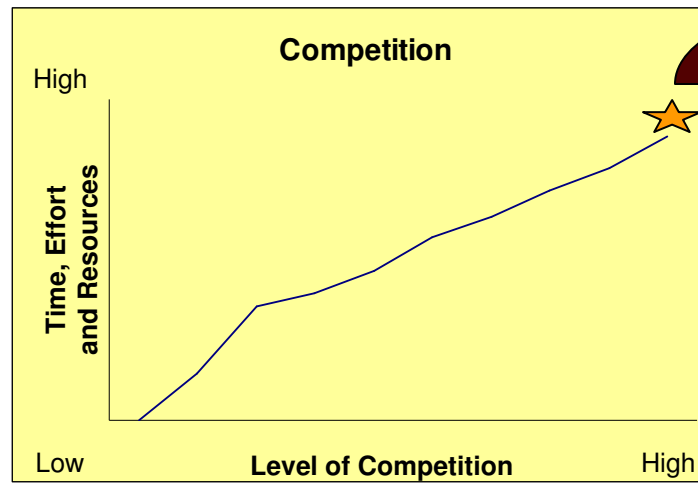


Revenue Focused:

- Budgets
- Profit Margins
- Expense Management
- Allocations
- Market Pressure
- Products & Services
- Revenue Models
- Sales Goals
- Account Retention

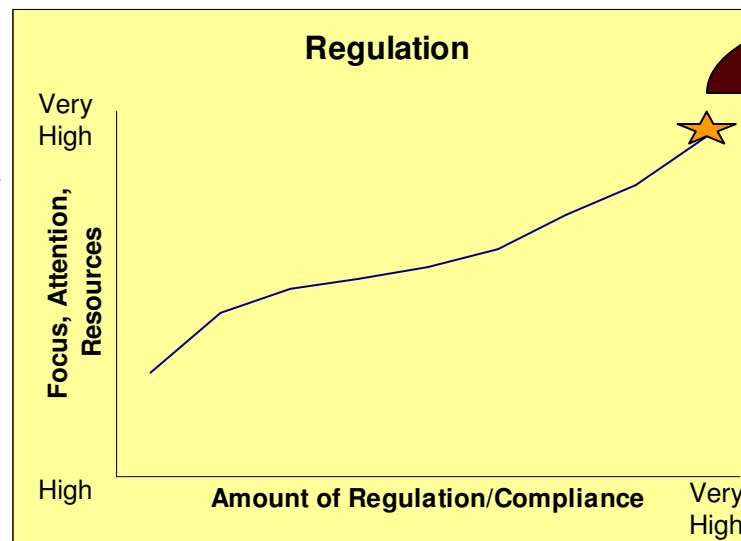
Industry Overview

- Retain **Existing** Accounts
 - Degree of Loyalty
 - Quality of Service
- Attract **New** Accounts
 - Level of Competition
 - Cost of Sales



What impact will competition and the quality of service provided have on your organization in the future?

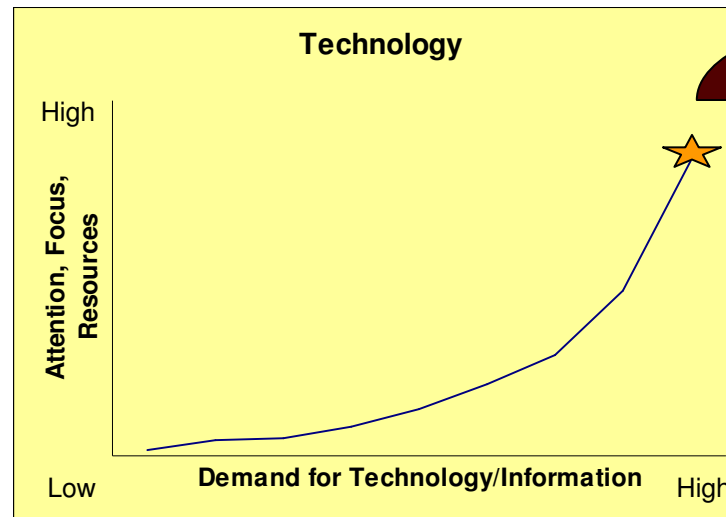
- Regulation will always exist
- **Risk vs. Reward**
 - Identification
 - Control
 - Measurement



What impact will regulation have on your business in the future?

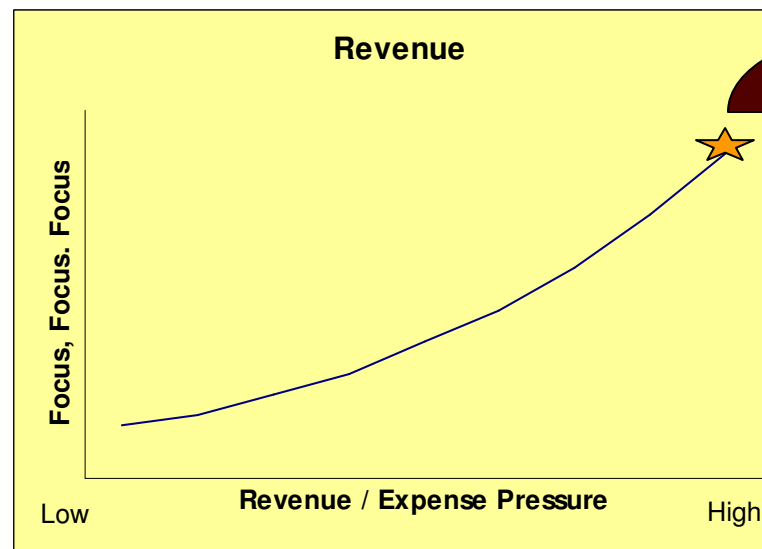
Industry Overview

- System Conversions / Upgrades
- **New System Platforms**
 - Additional Opportunities
 - Increased **Costs**
- New Information Demands



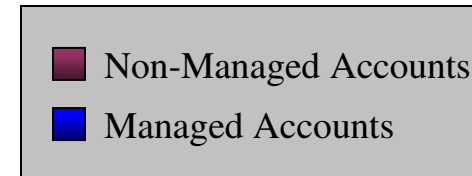
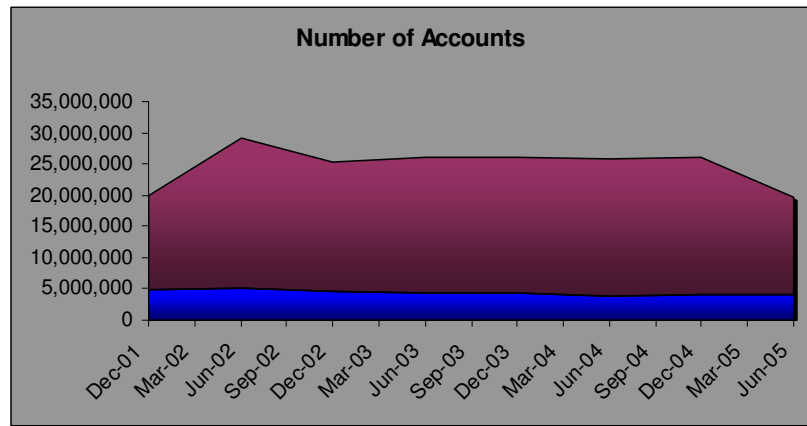
What affect will the demand for new technology and information have on your business in the future?

- **AUM Growth vs. Revenue Growth**
- Profitable Accounts
- Expense Recapture
- 80% / 20% Rule

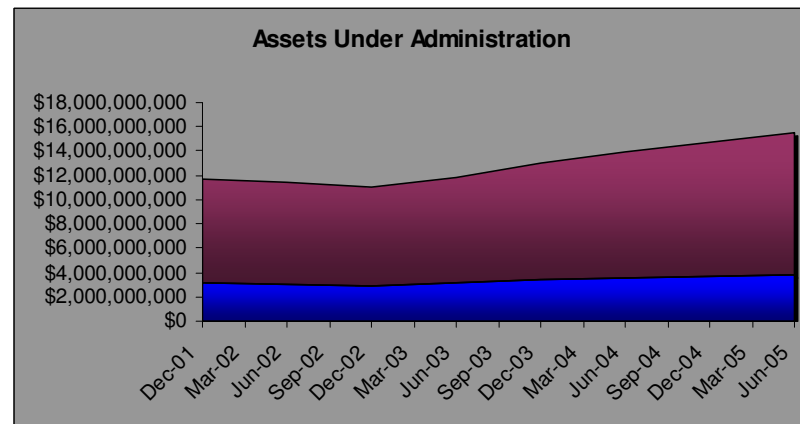


How will the demands for Profit Management be addressed by your organization in the future?

Industry Overview



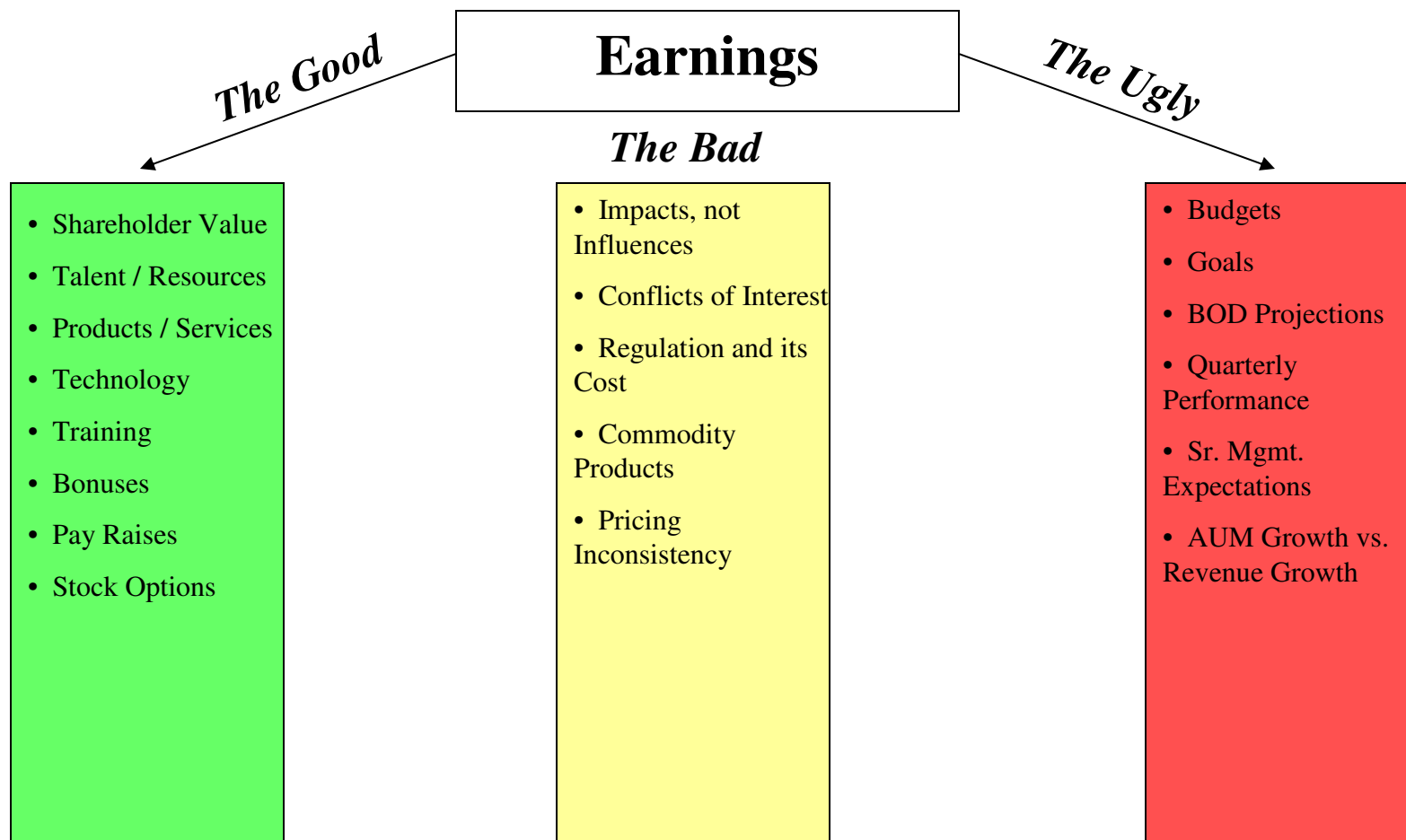
- In recent years the number of accounts has decreased as Assets under Administration has increased.
- Non-Managed accounts continue to dominate Assets under Administration.



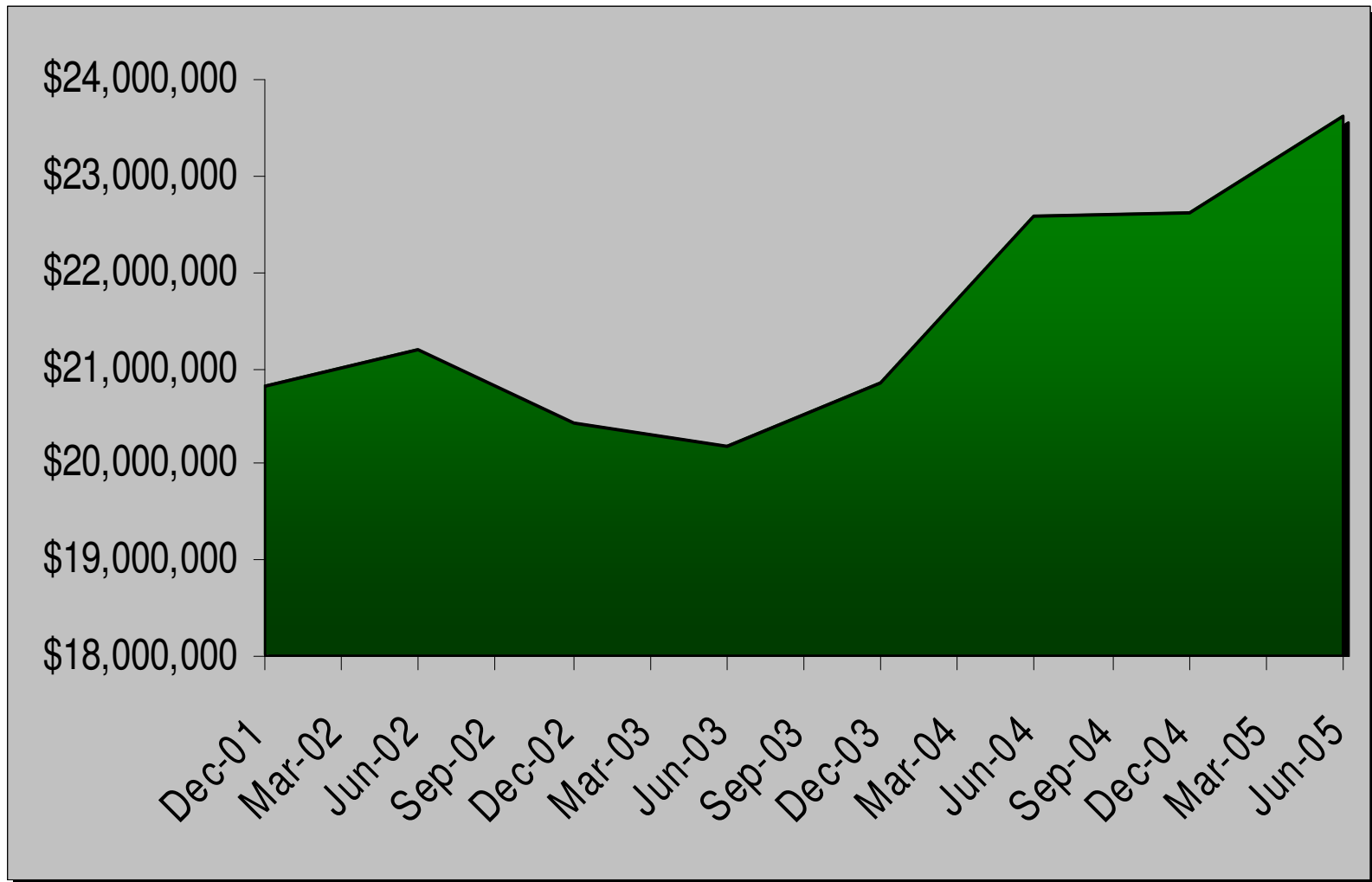
Numbers and Dollars are in Thousands.

Fiduciary Earnings

Never be frightened to take a profit. Michael Levy, Motivational Author

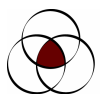
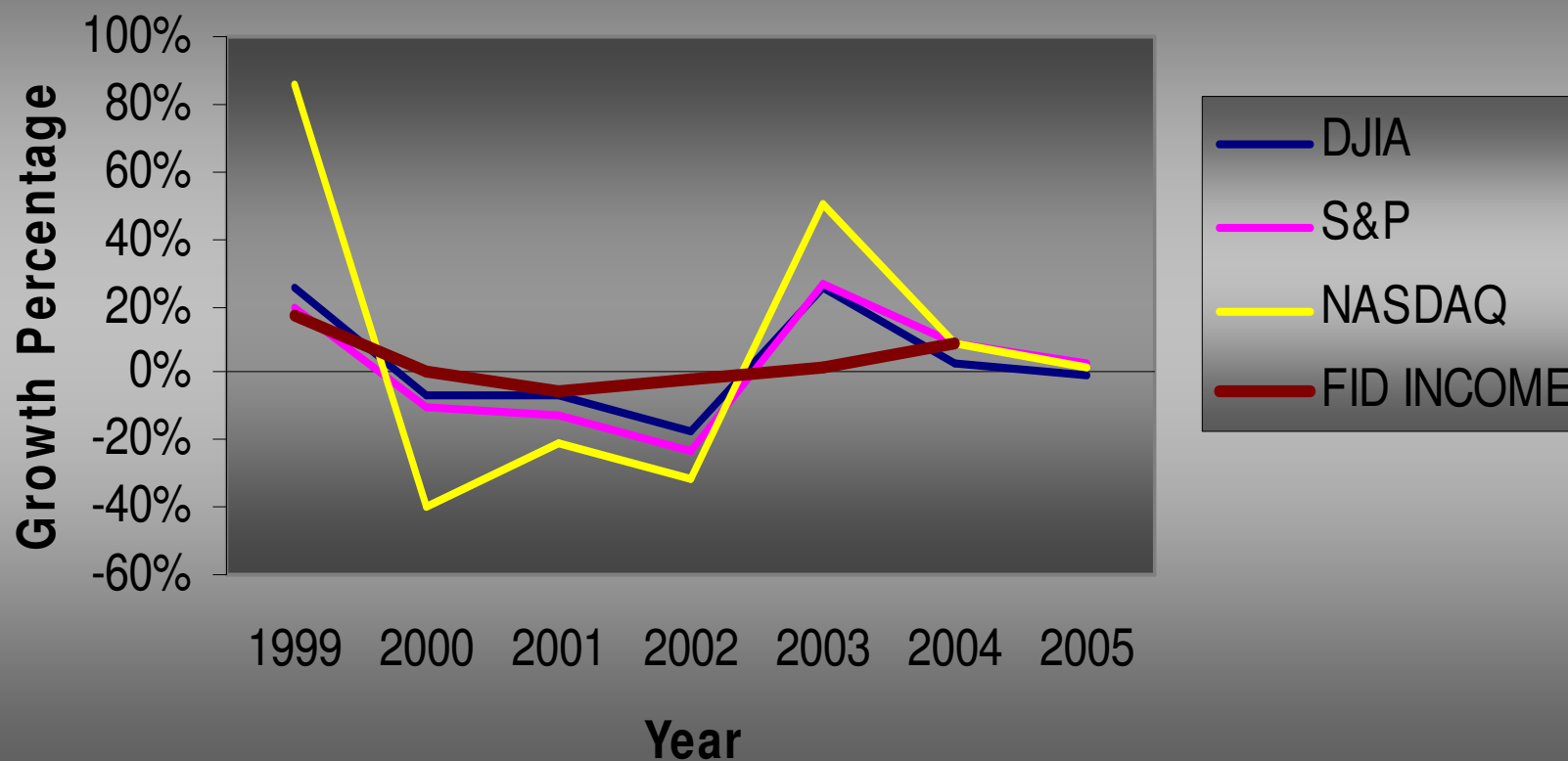


Fiduciary Earnings – Results

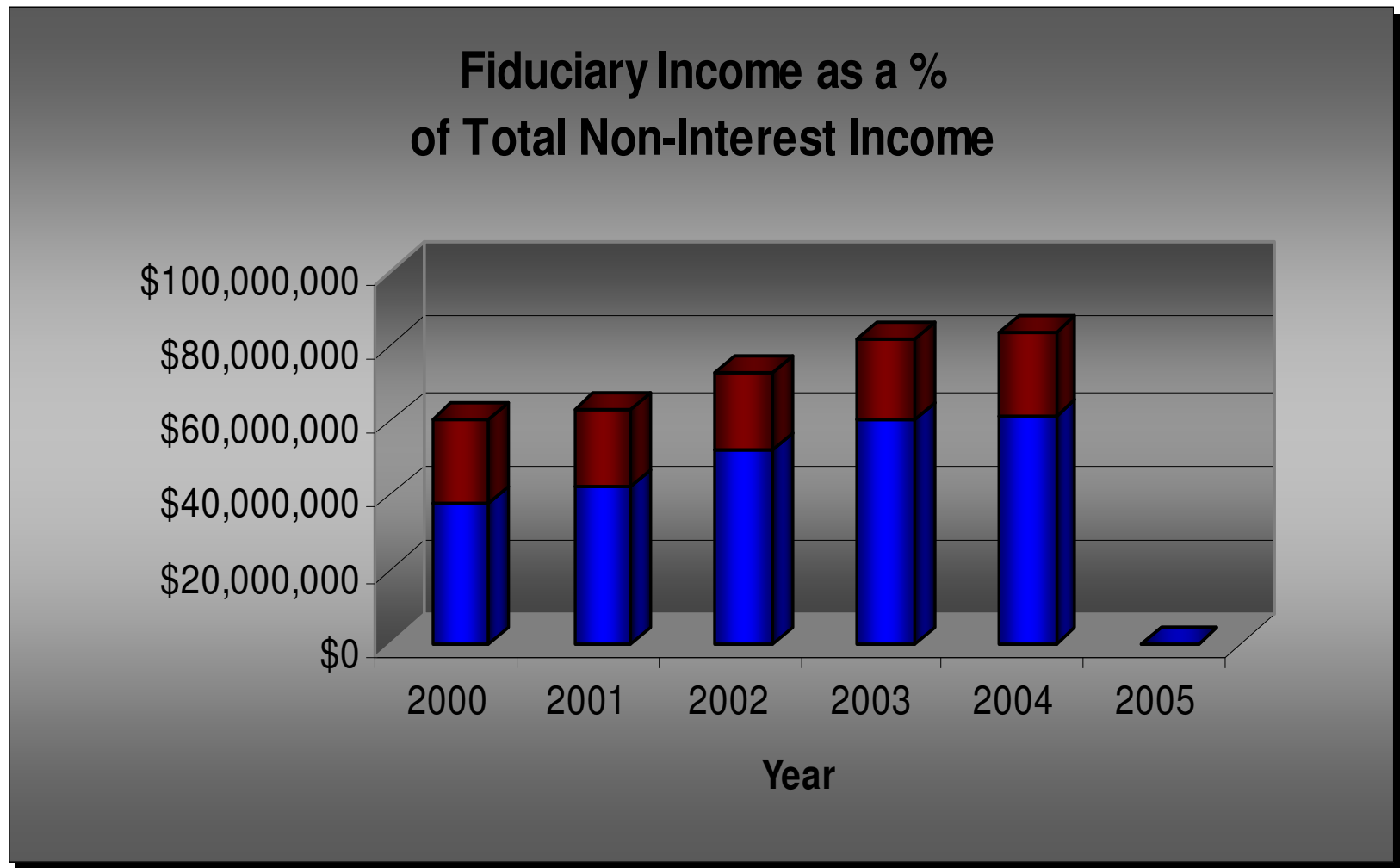


Fiduciary Earnings - Results

FIDUCIARY INCOME GROWTH RATE COMPARISON



Fiduciary Earnings - Results



Fiduciary Earnings - Ratings



- Regulatory Guidelines for Ratings
- Current Considerations
- What Next?

Regulation – The Good



The Lord's Prayer is 66 words, the Gettysburg Address is 286 words, there are 1,322 words in the Declaration of Independence, but government regulations on the sale of cabbage total 26,911 words. National Review

- Guidance
- Direction
- Opportunity
- *First to be Second??*

Regulation – The Ugly



- Costs
 - Studies in the 1990's estimated costs to be 12 -14% of Non-Interest Income, or approximately \$3.2 billion annually. (Gregory Elliehausen, Staff, Board of Governors 1998)
 - Opportunity Costs: When regulation prevents an institution from engaging in profitable opportunities.
 - Operating Costs: Arise from requirements that instruct institutions to perform certain actions.
 - Start-up Costs
 - Ongoing Costs
 - ***** **These studies did not specifically address the regulations impacting the Trust and Asset Management industry!**
 - Today, ABA estimates to total cost of compliance to range from \$34 to \$42 billion a year – this projection does not include the cost of legislation enacted since studies were done, including the Patriot Act, Sarbanes-Oxley, and the GLB Act. Add to that the costs of rules and guidance from the SEC, FASB, and the Public Company Accounting Oversight Board. (Harry H. Simmons, ABA Chairman, December 2005)

Regulation – The Bad



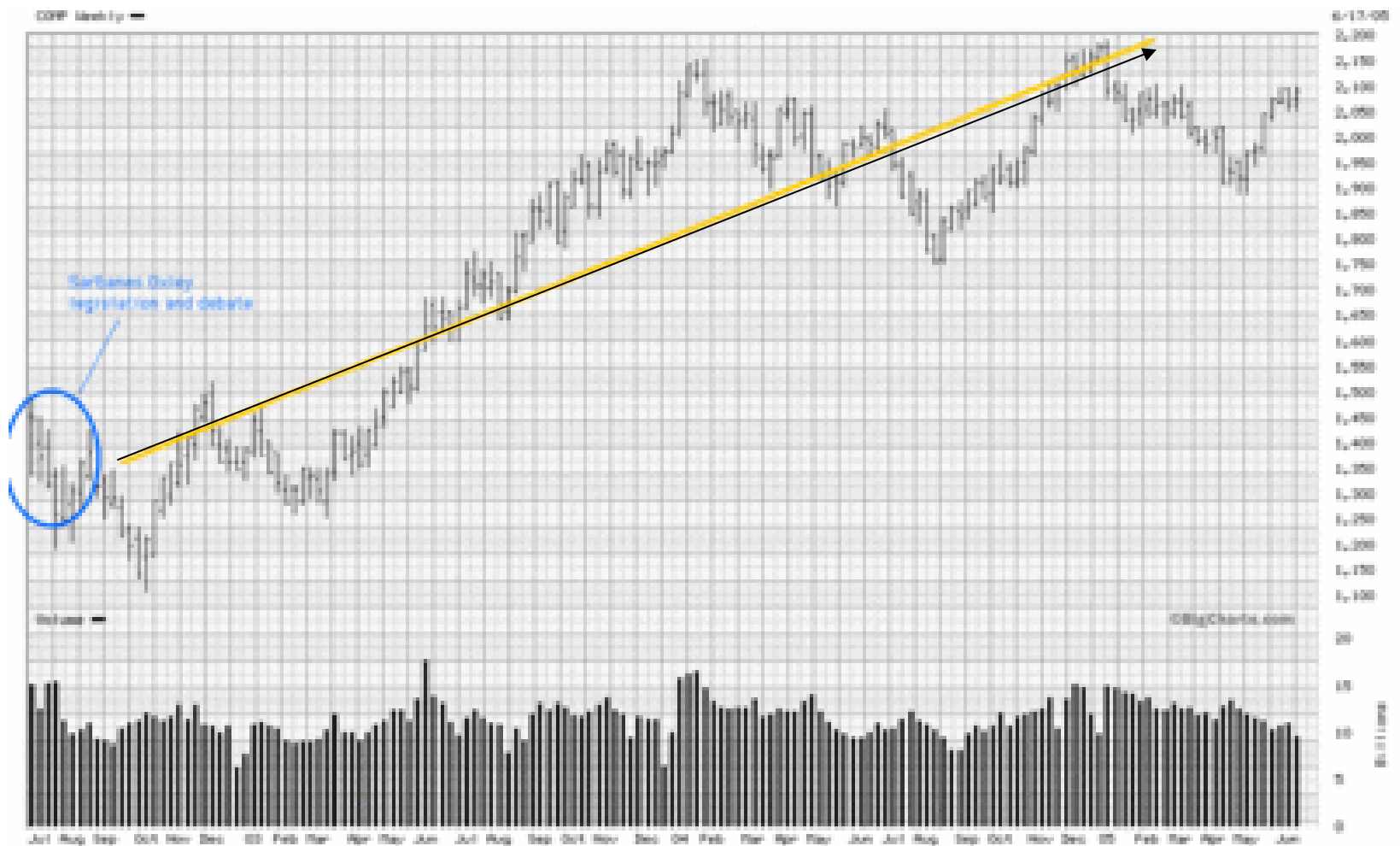
- Perception or Reality?
 - Former SEC Chairman Harvey Pitt cautioned bankers in a 2005 speech that the environment for the foreseeable future will consist of:
 - Over legislation;
 - Overregulation; and
 - Over prosecution

 - Need to **Self-Regulate** and **Self Police**

Regulation



Regulation



Shingle Theory

The shingle theory holds that any individual or business representing to the public that it provides goods and services - by the very act of hanging out its shingle - communicates that the consuming public can reasonably rely upon that professional and company to possess appropriate levels of competence so that the work such professionals and organizations do is characterized by appropriate levels of quality, skill and competence.

Thus, every individual and organization associated with Trust and Asset Management industry are expected to be competent in their roles generally, and to deliver goods and services that meet society's quality expectations specifically.

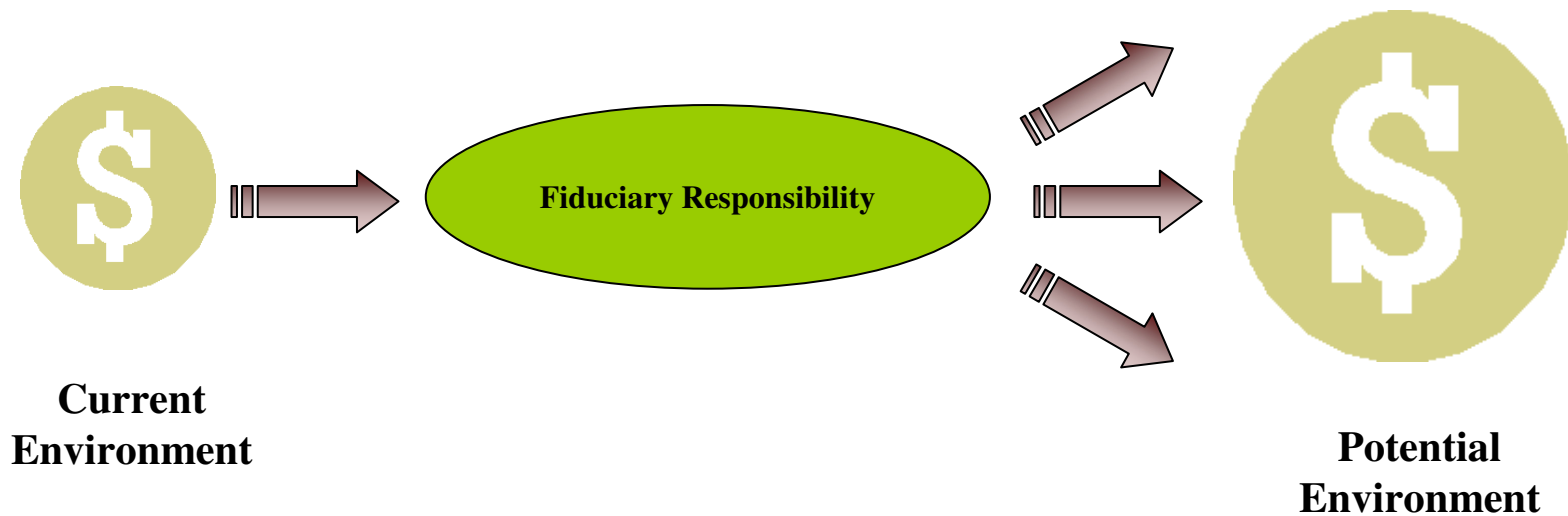
Shingle Theory = Fiduciary Responsibility

AND

Fiduciary Responsibility Leads To . . .



Opportunities



Pricing and Fee Structures

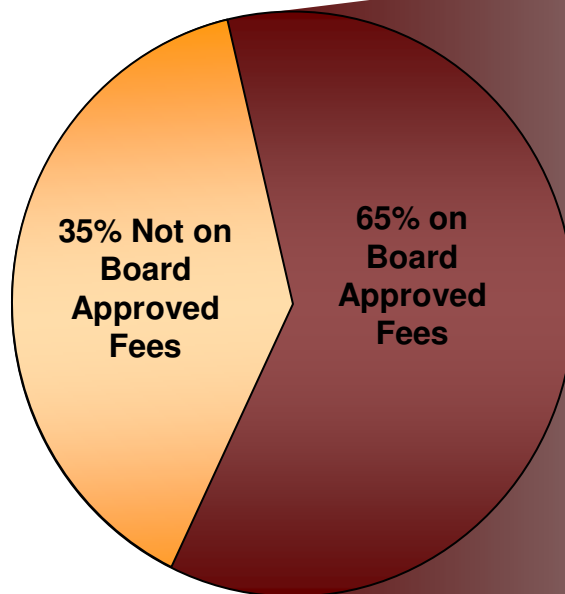
- Pricing Relative to Competition
- Existing Accounts vs. New Accounts
- Pricing Schedules are Varied and Many
 - Pricing Consistency - NIMBY
 - 80 – 20 Rule
 - Real Cost of Service & Profit Margin
 - Discounting – Where and when is it appropriate?
 - Gather AUMs or Make Money?
- Pricing Differential

Pricing and Fee Structures



- Pricing Methods and Alternatives
- Market Value Pricing vs. Non Market Value Pricing
- *Fiduciary Baggage – Status Quo*

Pricing and Fee Structures

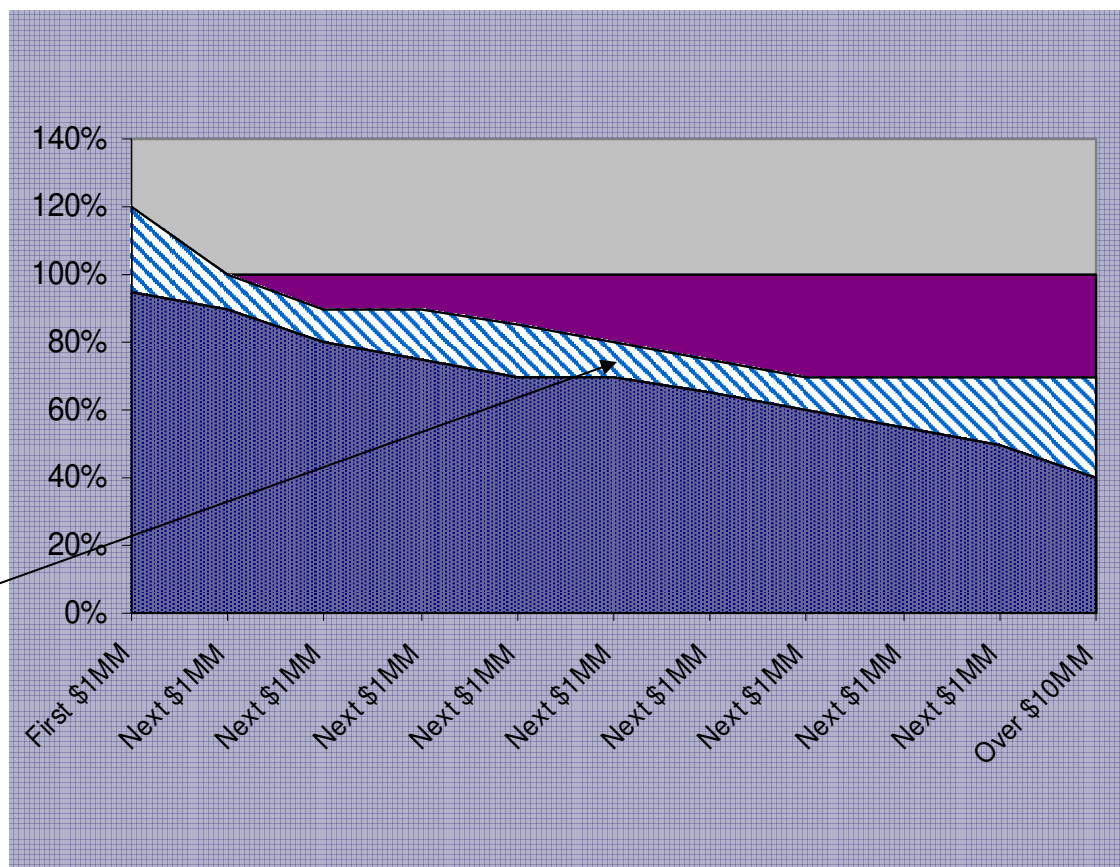


- How many accounts are not on the current fee schedule?
- How many accounts are not Paying Minimum Fees?
- How many accounts are not Paying Market Value Fees?
- How many accounts are not Paying Activity or Ancillary Fees?

Pricing and Fee Structures

- Revenue Consistency
- Revenue Proficiency
- Revenue Adequacy

Revenue Add



Hard to Value Assets

- Hard to Value Assets are defined as all assets other than marketable securities. Such assets include:
 - Partnerships
 - Mortgages
 - Insurance Policies
 - Closely Held Business
 - Real Estate
 - Collectibles
 - Mineral Interests
 - Jewelry
 - Art

Hard to Value Assets

- Fiduciary Responsibility – *The Ugly*
 - Manage the entire account to be the overall objective.
 - Review all assets to determine suitability
 - Understand the effect each asset has on the overall portfolio
 - Protect and safeguard each asset
- Fiduciary Duty – *The Bad*
 - Review each asset and document per 12 CFR 9, ERISA, and other applicable regulations
 - Determine the market value price of each asset for reporting purposes – Call Report Schedule RC-T; Form 5500; Client statements; etc.
 - Provide the necessary custody and safekeeping services
 - this can be somewhat difficult depending on the asset.

Hard to Value Assets

- Fiduciary Benefits – *The Good*
 - Properly valued assets increase revenue and decrease liability
 - Fee Schedules for Unique Assets, in some form or fashion, exist at a large percentage of institutions – 90% plus.
 - These Fee schedules however tend to be outdated
 - This pricing mechanism however is rarely implemented to the full extent.
 - Pricing Services do exist
 - Cost of valuation can be recovered from the client

Life Insurance Trusts



There are worse things in life than death. Have you ever spent an evening with an insurance salesman? Woody Allen

- Risk Identification – ***The Good!***
 - Risk Management – ***The Bad!***
 - Risk Control – ***The Ugly!***
 - **Risk Reward – *The Really Ugly!***
-
- Over \$1 trillion and growing face amount of Life Insurance held in trust accounts. (Arnold, Jr. and Harper, American Banker 2/3/98)
 - May 2003 study found the following: (Harris and Prince, Trust and Estates, May 2003)
 - 83.5% of professional trustees had no guidelines and procedures for handling Trust Owned Life Insurance.
 - 96.3% had no policy statements on how to manage Life Insurance investments.
 - Revenue from TOLI administration around 20% of Board approved fee schedules.

Life Insurance Trusts



- Prudent Investor Rule – *Reasoned Investment Strategy*
- Basic Duty is to Maximize the Probability of a Favorable Outcome
- Critical Asset Management Considerations
 - **Product Suitability;**
 - **Premium Adequacy; and**
 - **Carrier Selection**
- Reviews – Per OCC Regulation 9
 - Pre-Acceptance Reviews (12 CFR 9.6a)
 - Post Acceptance Reviews (12 CFR 9.6b)
 - Periodic Reviews (12 CFR 9.6c)
- Guaranteed Policies vs. Non-Guaranteed Policies
 - Transfer Premium Adequacy Risk
 - » Or
 - Retain Premium Adequacy Risk

Life Insurance Trusts



- Unmanaged Liability - RISK
 - 35% of TOLI Policies are non-guaranteed death benefit policies. (TrustBuilder Services 11/14/03)
 - Most non-guaranteed policies are underperforming their benchmark values. (Whitelaw and Weber, Estate Planning, Sept. 2005)
 - Non-guaranteed policies managed by trustees tend to lack TOLI management expertise.
 - Carrier illustrations do NOT predict future policy values and do NOT evaluate premium adequacy risk.
- Restructuring
 - Duty to Inform Beneficiaries
 - Actuarial Evaluation
 - Options:
 - Increase Premiums to replenish the Accumulation Account
 - “No-lapse” guaranteed universal life policy
 - Enter the Life Settlement market
- Breach of Trust
 - No evaluation of premium adequacy
 - Knowledge and failed to take action
 - Disputes are settled, not litigated

Life Insurance Trusts



- Managed Asset - REWARD
 - Adequate Pricing for the Service
 - Free to Negotiated
 - Auto-Collected or Invoiced
 - Accounts Payable Record – Collect at Maturation
 - Differential Pricing for Service
 - Cost Recovery/Recapture
 - Alternative Planning Opportunities
 - Life Settlement Alternatives
 - Additional “traditional” Assets

401k Due Diligence Reviews



- *The Ugly* – Government officials now expect plan sponsors to conduct periodic due diligence reviews.
 - DOL: Plan sponsors have a duty to periodically investigate plans and benchmark funds and fees.
- *The Bad* – Most plan sponsors do NOT have the in-house skills to do so.
 - Plan sponsors could be potentially liable for less than stellar 401(k) account growth if the participants can claim that the sponsor did not meet their fiduciary duty!
 - Can a financial institution seek shelter behind 403(c) rules of ERISA???????
- *The Good* – Expand service offering to current clients and open the door to new clients by conducting due diligence reviews.

Tax Benefits of Shifting States



Philosophy teaches a man that he can't take it with him; taxes teach him he can't leave it behind either. Mignon McLaughlin, *The Second Neurotic's Notebook*, 1966

- Fiduciary Duty – *The Ugly*
 - Tax Mitigation and Tax Strategies
 - Individual States are raising various taxes to counter budget deficits – How to escape the tax bite???
 - States without personal income tax include:
 - Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming
 - Increased interest in moving existing irrevocable trusts to these “no” or “low” tax states

Tax Benefits of Shifting States



- Fiduciary Responsibility – *The Bad*
 - Identify all irrevocable trust accounts
 - Determine benefits of shifting states for tax purposes
 - Incorporate into overall plan
 - Make recommendation

Tax Benefits of Shifting States



- Fiduciary Benefits – *The Good*
 - Increased Credibility and Referrals
 - Increased Revenue Opportunities
 - Administrative Expenses
 - Legal Assistance
 - Additional Assets
 - Referral and/or Revenue Share from Directed Trustees
 - Mitigation of Potential Liability

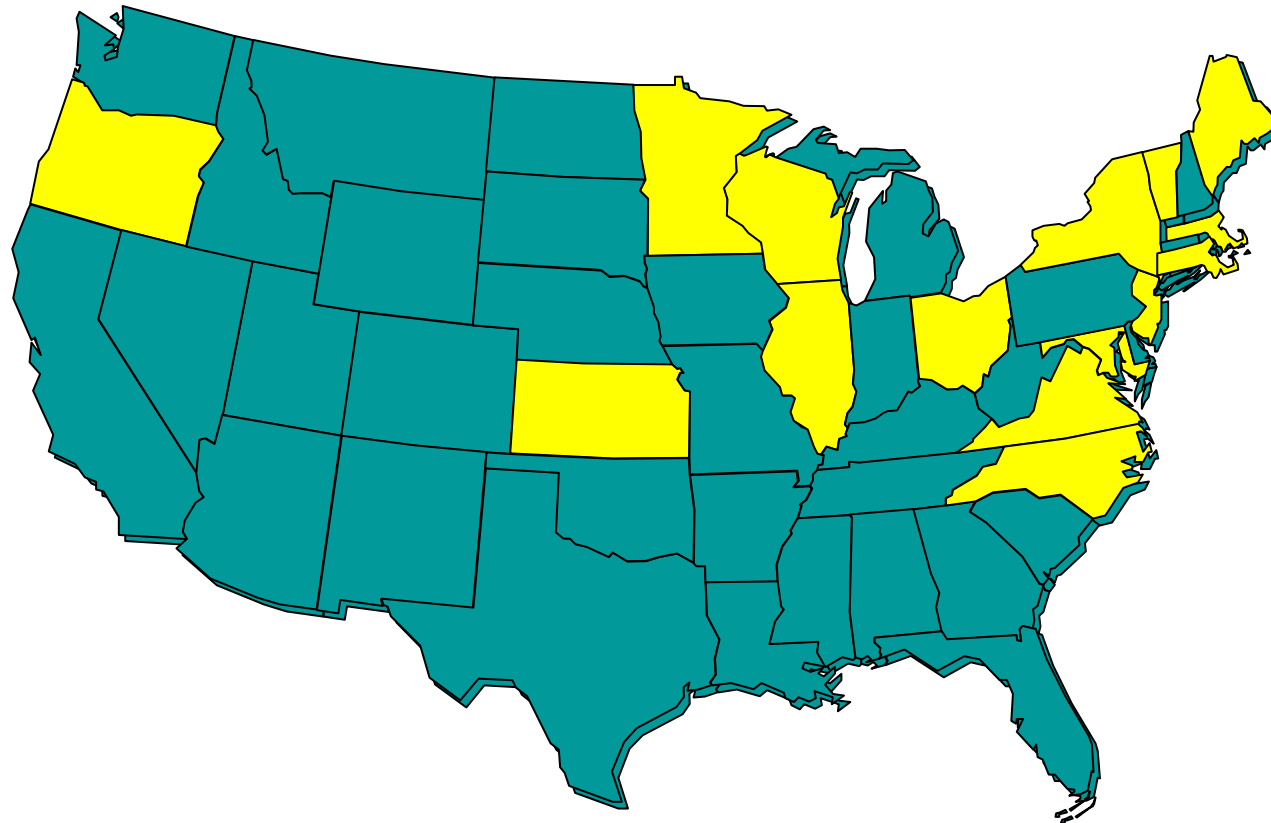
Tax Benefits of Deathbed Gifts



- Fiduciary Duty – *The Ugly*
 - Tax Strategies for Trust accounts may need to be reviewed.
 - Many states are experiencing a decline in their estate tax revenue – this has led to a decoupling from the federal estate tax system.
 - Although the 2001 federal estate tax law was designed to reduce estate tax burdens – this has resulted in the possibility of residents facing higher estate taxes in these decoupled states

Tax Benefits of Deathbed Gifts

States that have decoupled from the federal estate tax system



IL; KS; ME; MD; MA; MN; NJ; NY; NC; OH; OR; RI; VE; VI; WI; & DC

Tax Benefits of Deathbed Gifts



- Decoupled States have Different Rules – *The Bad*
 - Higher Tax Rates
 - Different Brackets
 - Lower Amounts Shielded from Taxes
- Decoupled States have Different Rules – *The Good*
 - No Tax on Transfer of Financial Assets prior to Death
 - No 3-year Look Back

Qualified Intermediary for IRS 1031



- Required – In order to complete a “like-kind” exchange under the IRS 1031 rules, and QI is needed.
- Independent – previous engagements within the past two-years generally prohibit serving as a QI.
 - Routine financial services, including Trust services, are not included in the prohibition.
 - Failure to obtain independence can taint the entire transaction, resulting in immediate taxation on any gains.
- Duties – act as principal for the exchanger of the property.



Qualified Intermediary for IRS 1031



- Duties include:
 - Paperwork
 - Oversight
 - Escrow Services
 - Hold exchange proceeds
 - Disburse proceeds to seller of replacement property
 - Expertise
 - Ensure the exchange qualifies under 1031 rules
 - Compliance with 45 day identification deadline
 - Compliance with 180 day exchange deadline
 - Communicate with all parties (Accountant, Attorney, Real Estate Agent, and Lender)

Qualified Intermediary for IRS 1031



- Investment of Funds held by QI
 - Funds can be invested
 - Usually invested in Money Market Fund
 - Daily Liquidity
 - Competitive Rate
 - All interest earned is credited to the taxpayer
 - Taxpayer must NOT withdraw any interest during the exchange period
- Fees for acting as QI
 - Fee for Service, flat rate of \$1,000 minimum
 - Percent of Transaction
 - Fund Revenue – must be disclosed

Open Architecture

- Talk the talk, but are they walking the walk?
- Buy or Build?
- Offensive or Defensive?
- Required Account Size
- Pricing

Other Good, Bad, & Ugly Items



- Audit – Does it still function?
- Compliance - Where should it report?
- Revenue Sharing – Who’s doing what?
- Conflicts of Interest – Disclose and Disclose
- Community Bank Trust and Investment Management – What works and where are the concerns?

Bearmoor, LLC



Bearmoor, LLC focuses on providing premier Asset Management and Fiduciary consulting services to the financial industry.

- **Increase Revenue**
- **Decrease Liability**
- **Do the Right Thing**

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