

Conflicts of Interest in Private Banking: Owners and Clients

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ABSTRACT

This paper describes a crisis of confidence among wealthy families with their advisors, primarily private banks, and the root causes of this issue. The authors argue that the crisis of confidence is primarily caused by conflicts of interest arising from ownership models in private banking. The authors describe the common ownership models, and their primary weaknesses. Then the authors describe six specific situations that present conflicts of interest between owners of private banking firms and their clients. The authors describe an alternate ownership model, that of a mutual bank. They cite the principles of cooperative business as promulgated by the National Cooperative Business Association. Finally, the authors argue that the mutual ownership model is a unique vehicle for wealth transfer to heirs and other beneficiaries due to its practice of accumulating capital and offering services at competitive fees.

INTRODUCTION

The financial panic of recent months has exposed deep-seated problems in the private banking business, resulting in a crisis of confidence among wealthy families and their advisors. While media coverage has focused on troubled commercial and investment banks, politicians were preoccupied with stabilizing financial markets. Away from the public gaze the nation's wealthy have been wrestling with issues at least as difficult, if not as well known.

Among the problems facing the clients of private banks:

- Lack of proper attention to capital preservation
- Lack of continuity in trust officers
- Changes in bank ownership, which impact the quality of service
- Emphasis on transaction volume instead of service levels
- Expense and fee levels that are inconsistent with investment performance
- Investment recommendations based on bank profitability instead of client profitability
- Fragmented offerings and expertise, with important service areas downplayed, if not missing entirely

We believe the ownership model of private banks is the root cause of these problems because the ownership model introduces inherent conflict of interest between stockholders and clients, particularly trusts and their beneficiaries. The financial panic brought

these problems to the fore because it severely impacted the managements and shareholders of many private banks. New owners not only acquired stalwart firms such as Merrill Lynch and US Trust, but introduced new agendas. Others, like Citigroup and Lehman/Neuberger, fell victim to the misguided strategies of much larger trading operations, and either went out of business or paid the price of substantial losses, which crimped their private bank offerings. As for the alternative investments favored by many private banks owing to their hefty profit margins, they left investors with significant losses and frozen assets.

The fact that these problems become apparent when markets are under duress may hide the fact that they are there all the time. When market returns are generally high, clients may not notice that high fees and expenses are draining principal away from their portfolios. Those same good returns may mask investment risks that are inappropriate for the client, and the good overall performance of the private bank's parent may mask its vulnerability to acquisition or massive trading losses. Only when markets turn decisively downward do these hidden risks come to the surface. In this paper, we will describe the common ownership models and the conflicts inherent in them. Regardless of market conditions, these risks will be more apparent if the client knows what to look for.

When a private bank is investor owned, even if the owners are also the managers and employees, it is hard for the bank's owners to reconcile their objectives with those of their clients. The fiduciary duty of management to their owners invariably takes precedence over the bank's fiduciary duty to clients. While this can be a problem in advisory relationships, it is particularly acute in trustee relationships, in which the bank serves in capacity of a trustee or executor. As a result, clients must assert their rights directly when confronted with explicit conflicts, and they must rely on regulators to control conflicts through regulations and examinations. Oftentimes, however, the conflicts are subtle or perfectly legal, and therefore difficult, if not impossible, to prevent and detect.

OWNERSHIP MODELS AND THEIR WEAKNESSES

In virtually all cases, private banks are owned by independent shareholders, whether they be public companies or closely-held. In a small number of cases, shareholders are also clients that own public or non-public stock. In other cases, shareholders are employees. In all cases, the shareholders have different interests than clients. These differences diverge over time and under various circumstances, to the detriment of clients.

- **A wholly-owned subsidiary or department of a diversified financial services firm** - These private banks are usually a small cog in a much bigger wheel, and suffer the fate of playing second fiddle (or third, or fourth, or tenth) when it comes to resources. In addition, senior management often regards private clients as dumping grounds for profitable financial products, and maybe thinks of the private bank as a plum business to be sold if the parent institution falls on hard times.
- **An independent publicly-traded stock company** – Here the client's status is hostage to the earnings performance of the bank. The tendency of managements to target short-term performance, as reflected in stock price, is a well-documented shortcoming with all publicly traded companies. As the source of top-line revenue, the private client should be as prized by the bank as a champion thoroughbred is by

the racing stable, but is often thought of as simply a cash cow. Finally, publicly traded companies are always open to changes of ownership, either friendly or hostile.

- **A closely-held stock company owned by its senior employees** – In this case, as well, the client is hostage to the bank’s earnings performance, although management’s focus here is solely on earnings, not stock price. However, many of these private banks were started with the ultimate, if unstated, purpose of selling the institution once its business reaches critical mass. Because such an end objective is almost never stated to clients, they are often taken by surprise if and when it happens. And the specter of a sudden sell-out leaves many clients of these banks perpetually on edge, and may affect employee morale as well.
- **A closely-held stock company owned by one or more founding families** – These companies, often started by large family offices as a way to spread their costs and enhance their revenues, expose non-owning clients to a service model that is dictated by the owning families. While non-owning clients may think that the owners’ motivations should approximate theirs, they are often distressed to find that the advice they are paying for is simply a reflection of the needs of the owning families. In addition, there is often some discomfort with having their private concerns and needs under the control of “competing” organizations.

COMMON CONFLICTS OF INTEREST

Conflicts of interest arise in private banking between owners and clients due to the profit motive of owners. Profit motive is not inherently insidious, but it often leads to outcomes that favor owners to the detriment of clients. In each of the common conflicts of interest we describe, the profit motive is the underlying cause.

- **Pricing** – Management set prices to realize a profit for the benefit of shareholders. Owners are, of course, seeking a profit and return commensurate with capital markets, thus putting upward pressure on pricing. Clients pay this profit premium. Fees charged to investment and trust accounts, however, diminish the value of the corpus of a trust or the principal of an investment portfolio, thus imposing opportunity cost from the diminished future value of the portfolio. The higher the fee, the greater the future impact of lost investment gains. Over twenty years, fees and opportunity costs can be tens of millions of dollars on a portfolio with a starting value of \$20 million.
- **Cross-selling** – In diversified investment firms and commercial banks, high net worth investment and trust accounts are attractive business because they are good prospects for cross-selling other investment, fiduciary, and banking products. This raises at least the appearance of a conflict of interest – when the investment advice benefits the firm providing the advice.
- **Service quality in market downturns** – when stockholder-owned companies experience reductions in revenue, they seek to minimize the impact on their profit and stock price by reducing costs of operations. In market downturns, this is often accomplished by reducing staff across the board. When investment and trust department staffing is reduced to control payroll expense, the professionals with

knowledge of the client's requirements and trust instruments will either be terminated, or burdened by increased workload transferred from terminated staff. The consequence is a reduction in service quality and an increase in fiduciary risk.

- **Service quality in trust departments** – under normal market conditions, stockholder owned companies seek steady growth of earnings, sometimes by implementing centralized and standardized operations. Trust servicing is labor intensive and cannot be easily standardized and centralized to improve efficiency. The productivity of trust departments is a function of the skills and experience of the staff, as well as the complexity of the client relationships. As a consequence, trust departments are notoriously difficult to operate profitably, thus undermining stockholder interests. Typically, the consequence is slow erosion in service quality as owners attempt to sustain profit margins.
- **Business improvement and capital allocation** – in large diversified financial companies that provide private banking, the divisions that provide asset management and fiduciary services compete with other divisions for resources to improve operations and grow the business. Projects, such as system implementations, or introduction of new services, require staff and funding that are allocated judiciously by corporate management across a range of choices measured by the expected internal rate of return on the cost of the project. In many instances, the smaller business units, such as trust departments, with lower margin, cannot compete for staff and funding because they don't deliver internal returns competitive with bigger and more profitable business lines. As a consequence, trust departments and private bank divisions of large institutions are starved of sufficient resources to sustain high quality service.
- **Corporate transactions impact continuity in fiduciary relationship** – Over the last decade, a number of corporate transactions have occurred that enriched the shareholders (and often management, who owned substantial numbers of shares) but provided no apparent benefit to clients. In many cases, the transactions resulted in loss of independence of the bank or investment firm, and resulted in fee increases, reduced service quality, and other failures to satisfy the needs of clients. This is not only a phenomenon among larger institutions, but is a very common occurrence among small advisory firms owned by a small group of partners once they reach retirement age. However, clients desire multi-generational continuity in the relationship they have with their fiduciary. Clients want confidence that the firm that has been serving their family for generations, and that understands their unique trust instruments, will continue serving their heirs.
- **Proprietary trading** – Large diversified banks with sophisticated in-house trading capabilities are known to dedicate substantial infrastructure and intellectual capital to maximizing their returns on the bank's proprietary investments. This typically deprives other divisions of the bank of the skills and capabilities to provide clients the same investment opportunities and results.

ALTERNATE OWNERSHIP MODEL

An alternate ownership model that balances the interests of clients, owners, and the organization is that of a client-owned private bank, following the model of a mutual savings association that can provide all the same services as a commercial bank including fiduciary and asset management services. This model has great appeal to wealthy families, providing, as it does, control over service models, organizational structure and independence. Mutual banks apply the principles of cooperative business, within the limits imposed by banking regulatory control. This idea was applied by John Bogle in founding Vanguard Investments, and has demonstrated that mutual ownership can deliver significant long term benefits to investment clients.

Cooperative businesses operate in a wide variety of industries, including banking. More than 530 mutual banks operate in the United States under federal and state regulators, with approximately 15% of all bank deposits. In Europe, cooperative banks have approximately 20% of all deposits, some of which include private banking services and products (Oliver Wyman).

Cooperative businesses hue to seven tenets, known as the Rochdale Principles, originally established in Rochdale, England in 1844, and since promulgated and updated by the International Co-operative Alliance (ICA) and, in the U.S., the National Cooperative Business Association. In short, cooperative businesses and their clients (aka, members) are accountable to themselves for good governance and business success. This requires capital support as well as involvement by members to ensure that the organization achieves its goals.

The following is the Statement on the Co-operative Identity, published by the ICA:

Definition

A co-operative is an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise.

Values

Co-operatives are based on the values of self-help, self-responsibility, democracy, equality, equity and solidarity. In the tradition of their founders, co-operative members believe in the ethical values of honesty, openness, social responsibility and caring for others.

Principles

The co-operative principles are guidelines by which co-operatives put their values into practice.

1st Principle: Voluntary and Open Membership

Co-operatives are voluntary organizations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political or religious discrimination.

2nd Principle: Democratic Member Control

Co-operatives are democratic organizations controlled by their members, who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership. In primary co-operatives members have equal voting rights (one member, one vote) and co-operatives at other levels are also organized in a democratic manner.

3rd Principle: Member Economic Participation

Members contribute equitably to, and democratically control, the capital of their co-operative. At least part of that capital is usually the common property of the co-operative. Members usually receive limited compensation, if any, on capital subscribed as a condition of membership. Members allocate surpluses for any or all of the following purposes: developing their co-operative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the co-operative; and supporting other activities approved by the membership.

4th Principle: Autonomy and Independence

Co-operatives are autonomous, self-help organizations controlled by their members. If they enter to agreements with other organizations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain their co-operative autonomy.

5th Principle: Education, Training and Information

Co-operatives provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of their co-operatives. They inform the general public - particularly young people and opinion leaders - about the nature and benefits of co-operation.

6th Principle: Co-operation among Co-operatives

Co-operatives serve their members most effectively and strengthen the co-operative movement by working together through local, national, regional and international structures.

7th Principle: Concern for Community

Co-operatives work for the sustainable development of their communities through policies approved by their members.

Within the banking context, mutual savings associations are capitalized by organizers with the pledge of deposits that can not be withdrawn until the bank achieves certain financial goals and the distribution is approved by the bank's regulator. The bank's depositors and other account holders are its members and have voting rights in much the same fashion as stock-holders. The members elect the board and approve other vital measures that are put to a vote in an annual meeting. The members also have a claim to capital in the event of a capital distribution or voluntary dissolution of the association. Deposit account members cannot be assessed for additional capital, but they may participate in additional deposit pledges or purchase mutual capital certificates, which are similar to convertible stock.

In addition to the obvious advantages of this ownership model in avoiding conflicts of interest with independent owners, mutual banks also offer a unique vehicle for wealth transfer to heirs and other beneficiaries. Mutual banks can accumulate capital instead of pay dividends. By so doing, mutual banks can maintain favorable pricing in advisory and banking products and services that ultimately lead to better long-term wealth preservation in client accounts.

CONCLUSION

The crisis of confidence in private banking has some obvious causes, most of which became more obvious in the wake of the housing crisis and then the collapse of Lehman Brothers in late 2008. It also has one not-so-obvious remedy, in the client ownership model. But that remedy requires a high level of involvement in all aspects of the business. For those families willing to make the commitment, the only confidence that matters may be in their own choices.

FURTHER READING

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