The Functions and Investment Policies of Personal Trust Departments

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Commercial banks are administrators of a large part of the nation's intangible wealth as well as a leading source of credit. Personal trust departments of the banks administer, as either trustee or agent, the largest pool of investment funds in the country today. These fiduciary funds[1] were valued toward the end of 1970 at $292 billion, equivalent to almost two thirds of the commercial banking assets held by the same banks. They were almost 50 percent greater than the pool of fiduciary funds administered by life insurance companies (see Table I). Approximately one quarter was concentrated in just five banks, and fully half in just twenty-one banks.[2]

Trusteed funds constituted about 80 percent of the $292 billion, with the banks having sole investment responsibility for a very large portion of these funds. For the rest of the $292 billion, the banks provided investment advice. Obviously, the way such sizable sums are handled could have important financial and economic implications. Yet, until quite recently there was hardly any public interest in the operations of personal trust departments and little was known about their activities.[3] The first instalment of this article reviews the principal fiduciary functions of these departments and analyzes their investment policies. The second instalment will indicate the contribution to total bank income from the trust department activities and comment on some ramifications of their operations.

TYPES OF ACCOUNTS

A bank can serve individuals as a fiduciary in several different capacities. As trustee, the bank has legal title to the assets involved. Under this kind of arrangement, the bank can act as trustee (or co-trustee) of a trust, as executor (or co-executor) or administrator (or co-administrator) of an estate, and as guardian of the property of minors and certain other categories of individuals. Another kind of fiduciary relationship is the agency, in which legal title to the assets is not vested in the bank. Since World War II, increasing numbers of banks have been offering various types of agency accounts.

When a bank acts as a trustee for individuals, it does so either under a will that has provided for the establishment of a trust (a testamentary trust) or under an agreement with a living donor (an *inter vivos* trust). As trustee, a bank must administer and distribute the income and assets according to the terms of the governing instru-

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[1] A "fiduciary" relationship denotes a relationship of high trust and confidence. This article does not deal with the trust and agency activities, other than those connected with employee benefit funds, that banks undertake for corporate customers and local government entities. These other services, which include acting as transfer agent and dividend disbursing agent, are generally rendered in a separate department, usually called the corporate trust department.

[2] Data are from *Trust Assets of Insured Commercial Banks—1970,* the third such annual report 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. One large bank was erroneously omitted from the 1970 report, which should have covered 3,407 banks. Subsequently, data for the missing bank were provided (and used in this study) by type of account, but no breakdown was made available on the asset composition.

[3] Considerable study had been undertaken, however, by several research committees within the Federal Reserve System.

Table I

INVESTMENT FUNDS MANAGED BY SELECTED INSTITUTIONAL ADMINISTRATORS, 1970

Market value, billions of dollars

Administrator	Amount
Personal trust departments	292.2
Life insurance companies	200.5
Investment advisers and companies*	75.6†
Mutual funds	47.6
Closed-end investment companies	3.0
Total	618.9‡

Note: This table excludes employee benefit funds that are administered by the corporations or the state and local governments that set up the plans, as well as the assets of self-administered foundations and educational endowments. It has been estimated that the assets of these groups totaled between $78 billion and $96 billion in 1969.

*Excludes mutual funds and closed-end investment companies.

†Figure for 1969.

‡One component figure is for 1969.

Sources: "Flow of Funds", *Federal Reserve Bulletin* (June 1972); *Trust Assets of Insured Commercial Banks—1970; Institutional Investor Study Report of the Securities and Exchange Commission* (March 10, 1971); and *1972 Mutual Fund Fact Book* (Investment Company Institute).

ment. Income of the trust is paid to the beneficiary or beneficiaries designated, and eventually the principal is distributed to the so-called remaindermen. Usually the bank alone decides how funds should be invested, but sometimes it shares this responsibility with co-trustees and others (such as relatives of the testator or donor, or the lawyer who drew the trust instrument). In formulating an investment program, a bank will take into consideration the client's needs and objectives, such as family circumstances, the client's need for income, his business interests, his other investments and investment income, and his income tax situation. Trusts for individuals reportedly have an average life of about twenty to twenty-five years when established under a will and a shorter life when established by a donor. It is unusual for a personal trust to last longer than forty years.[4]

A bank acts as an executor of an estate if it has been named in a will and has been subsequently appointed by a court. A court can also appoint a bank administrator of an estate when a person has died leaving no valid will, or if an executor named in a will is unable or unwilling to serve. The role of a bank as either executor or administrator is to conserve the property, convert into cash any property that is not to be passed on to beneficiaries in its existing form, pay debts and claims, and distribute the net estate to the beneficiaries as rapidly as feasible. For an average estate, the settlement process takes three to four years. Smaller estates may be settled in less than two years. Large complicated estates are sometimes under administration ten years or more because of delays in obtaining final clearance of the Federal and state estate or inheritance tax returns or because of the complexities of appraisal and liquidation.

A minor volume of trust business originates from appointment of a bank by a court as a guardian of a minor or as "committee" or "conservator" for a mentally incompetent person. In these capacities, a bank is charged with the duty of managing the person's property.

When a bank accepts a personal agency account, title to the assets is not vested in the bank and the agency terminates automatically on the death of the client.[5] Under some types of agency accounts, the client obtains the bank's investment advice and contracts with the bank for management-related services. Such accounts, which are the only types of personal agency accounts included in the $292 billion of fiduciary assets reported for 1970, fall into two broad groups: managing agency and advisory agency accounts.[6]

As managing agent, a bank analyzes the investments, reviews the portfolio periodically, and has full discretionary powers regarding portfolio changes. It can thus undertake transactions without prior approval of the client. Approval is usually obtained on an annual basis.

The advisory agency account is a more common type of

[4] Generally, a bank that is appointed testamentary trustee remains the trustee for the duration of the trust. On rare occasions, a bank will seek to resign as trustee due to a serious disagreement with a co-trustee, with a beneficiary, or with other interested parties; or one or another of these various parties may seek to have a bank removed as trustee. In either situation, if the move is successful, the bank must render an accounting to the court or to the interested parties, and the court then names a successor trustee.

[5] Some accounts are held by personal trust departments as agents for executors, or as agents for trustees of employee benefit funds or of endowment funds for colleges, churches, and charitable organizations. Usually these relationships entail the providing of custodial services and sometimes investment advice. Banks also act as agents for mutual funds.

[6] Either as managing or advisory agent the bank also performs custodial services, collects income, and advises the client of exchange offerings and other developments affecting securities in his portfolio. It should be noted that there is no consensus in trust banking circles regarding the proper labels for the various agency services.

appointment. Under this arrangement, the bank does not have full discretionary investment powers but reviews the portfolio and gives investment advice. Its advice is usually accepted by the client and, although approval in writing is required, the transaction is often carried out after telephone communication, with written consent being supplied subsequently.

During the sixties, a few banks attempted to increase the attraction of their agency services to smaller investors by offering commingled investment accounts in which clients' funds were pooled. (These were distinct from the common trust funds and the commingled employee benefit funds that had been in existence for many years prior to this development and that are discussed below.) However, these programs were regarded as directly competitive by open-end investment companies (the mutual funds) as well as by securities dealers. After a legal battle lasting four years, the Supreme Court handed down a decision in the spring of 1971 that prohibited banks from offering such commingled accounts. The Court ruled that such operations violated the 1933 Glass-Steagall Act, which separated the commercial banking from the investment banking business.

Aside from the various types of trust and agency accounts for individuals, banks, particularly the larger ones, administer employee benefit trusts. Such trusts may be established by business enterprises, labor and religious organizations, educational and charitable institutions, and state and local governments. They arise mainly from pension and profit-sharing plans, but also include trusts set up under stock bonus plans as well as under plans for aiding the incapacitated and stimulating employee savings.

Life insurance companies are the banks' main competitors for employee benefit trusts. Most of the employee benefit plans with insurance companies are "insured", with the insurance company guaranteeing an annuity on the amounts paid in. Such insured funds comprise less than one fourth of total private employee benefit plan assets. Insurance companies now also manage separate "noninsured" accounts. These accounts (for which the insurance industry began to obtain permission from state regulatory agencies about ten years ago) make available a much wider latitude for investments, particularly in equities, than is possible when employee benefit funds are commingled with general life insurance assets. This has improved the competitive position of the insurance companies *vis-à-vis* the banks, but such separate accounts still constitute only a very small portion of total private employee benefit fund assets.

In recent years the banks have had especially keen competition for the business of administering employee benefit funds from other quarters—brokerage firms, independent investment counselors, and open-end investment companies. Nonetheless, the overwhelming bulk of the private funds is still in the hands of the banks, in most cases as trustee.[7] Banks are also investment advisers for a minor part of the assets of employee benefit funds set up by state and local governments, but apparently only a negligible portion of these assets is held in bank trust departments. The degree of responsibility given to trustee banks for investment decisions regarding the employee benefit funds varies, but some of the larger banks usually demand and obtain sole investment responsibility. In some other cases, a trustee bank may act on investment matters only at the direction of an outside party, usually an investment counselor. If a bank serves as agent, it may render investment advice or may act only on instructions from an investment counselor or from a committee or other group appointed by the corporation for this purpose.

Small banks render primarily personal trust and estate services. It is mainly the large banks that offer the more comprehensive variety of fiduciary services, including employee benefit trust and agency account services. The five largest trust departments—those of Morgan Guaranty Trust Company, Bankers Trust Company, The Chase Manhattan Bank, N.A., First National City Bank, and United States Trust Company—held 24 percent of the total trust and agency assets of $292 billion reported toward the end of 1970 by 3,407 trust departments.[8] The fifty-three banks that administered fiduciary assets valued at $1 billion or more held almost 70 percent of the total.

The $292 billion represented an increase in total assets of over 50 percent in just six years. By very rough estimate, about one half of this growth reflected net price appreciation; the other half, net inflow. Almost half of the 1970 assets was in personal trust accounts or estates, with about $122 billion representing trust assets and only about $15 billion estate assets (see Chart I). Employee benefit trust funds, at $93 billion, accounted for slightly less than one third of the total. A little

[7] Employee benefit trusts, particularly pension and profit-sharing trusts, are not very often terminated, but this may occur when a corporation is dissolved. In such cases, the funds in the trust are sometimes used to purchase annuities from a life insurance company or to make lump sum payments.

[8] The data do not all refer to identical dates. The regulatory agencies noted in *Trust Assets of Insured Commercial Banks—1970:* "The assumption can probably be made that the bulk of trust assets were valued or reviewed during the second half of the year and mostly in December."

over one fifth of the total was held for agency accounts. The latter consisted primarily of accounts for individuals, all in the form of managing agencies or advisory agencies, with assets amounting to $52 billion; agency accounts for employee benefit plans where the banks render investment advice totaled only $10½ billion.

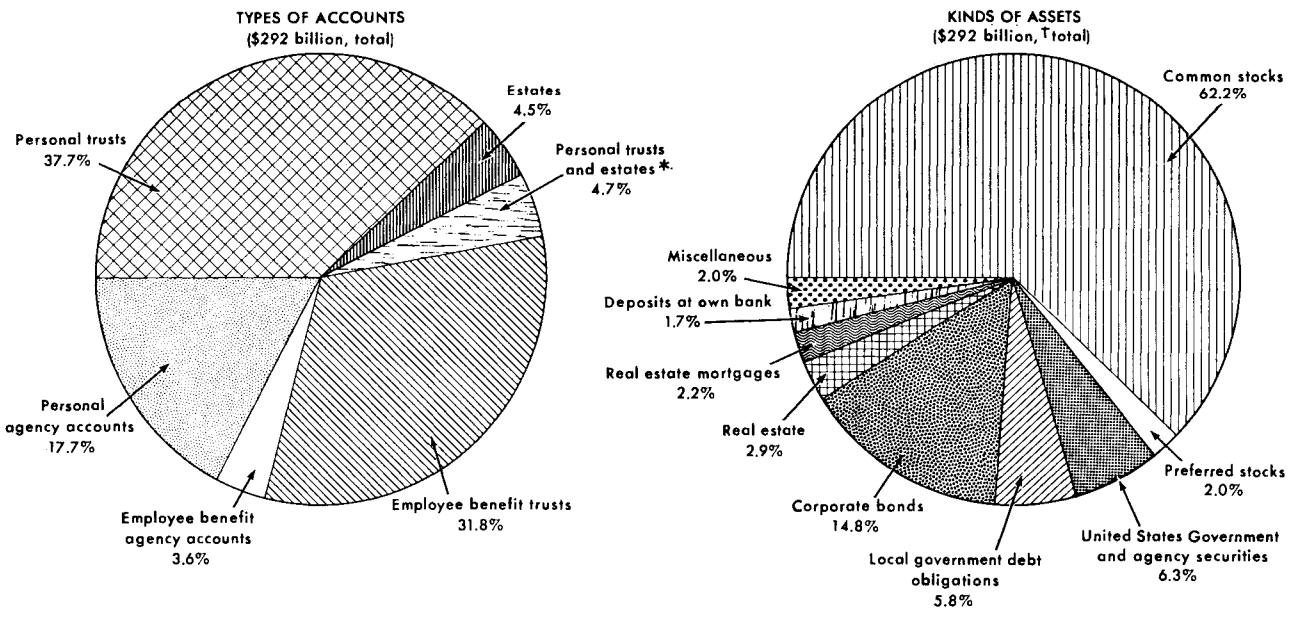
The expansion in fiduciary assets since the midsixties has been attributable more to the growth of employee benefit trust funds than to that of any other category of accounts (see Table II). Not only was the dollar increase greater, but so also was the rate of growth (see Chart II). Total agency accounts registered about the same dollar gain as personal trusts and estates, but the agency accounts grew at a considerably more rapid rate. However, this was substantially less than the growth rate of employee benefit trusts.

The increase in employee benefit fund assets represented primarily an enormous surge in pension funds; these now account for about 90 percent of the $93 billion total. Only 10 million persons were covered by private pension plans in 1950, but today the number is more than 30 million. It is anticipated that by 1980 the number will exceed 40 million.[9] This rapid expansion will be the principal factor swelling pension funds to what is expected to be a multiple of their current dollar amount—even on the assumption of no further price inflation. Several other factors will contribute to the growth in funds. The raising of pension benefits in relation to wage and salary levels and earlier vesting of pension rights are clear-cut trends. Larger inflows will also result if there develops an increase in "portability" arrangements, under which pension rights can be transferred from one place of employment to another (within an industry, for instance). Greater inflows will also occur if pension fund liabilities that have accrued in connection with past employee services are funded more rapidly.

[9] Daniel M. Holland, *Private Pension Funds: Projected Growth* (National Bureau of Economic Research, 1966).

Chart I

ASSETS IN PERSONAL TRUST DEPARTMENTS, 1970



Note: Data based on market values.

*Combined figure for banks where breakdown was not available.

† Asset percentages actually are based on $288 billion, but allocation of the $4 billion for which no breakdown is available could modify the shares only negligibly.

Sources: Trust Assets of Insured Commercial Banks--1970, joint survey by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency.

Table II

ASSETS IN PERSONAL TRUST DEPARTMENTS, BY TYPE OF FIDUCIARY ACCOUNT, 1963-70

Market value, billions of dollars

Year	Personal trusts and estates*	Employee benefit trusts	Total trust accounts*	Total agency accounts†	Grand total
1963	101.2	43.0	144.2	n.a.	n.a.
1964	105.5	50.3	155.8	35.0	190.8
1965	115.0	59.6	174.6	40.0	214.6
1966‡	113.0	61.5	174.5	47.0	221.5
1967	126.2	72.9	199.1	54.2	253.3
1968	138.4	84.3	222.7	60.0	282.7
1969	132.8	86.4	219.2	60.9	280.1
1970	137.1	92.8	229.9	62.3	292.2

Note: Through 1966, figures are estimates for all commercial banks. Later figures are from surveys of insured commercial banks; noninsured banks hold only a very small volume of fiduciary assets.

*Through 1965, includes minor amount of managing agency accounts.

†Through 1965, consists of advisory agency accounts only; thereafter, includes also managing agency accounts. In 1970, personal agency accounts comprised 83 percent ($51.8 billion) of the total, and employee benefit agency accounts only 17 percent ($10.5 billion).

‡Break between 1965 and 1966 in some series; see foregoing footnotes.

Sources: 1963 through 1966, Office of the Comptroller of the Currency; 1967, *Commercial Banks and Their Trust Activities: Emerging Influence on the American Economy*, Committee on Banking and Currency, House of Representatives (July 9, 1968); 1968 through 1970, *Trust Assets of Insured Commercial Banks*.

Earlier vesting, increased portability, and more rapid funding have all been the subject of debate during recent Congressional sessions.

INVESTMENT POLICIES

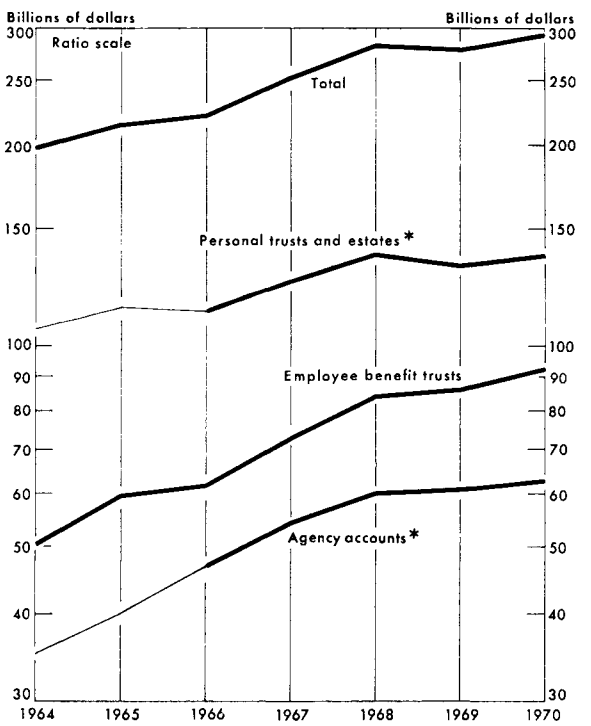
The investment of funds a bank holds as a fiduciary is generally subject to two overriding categories of restraint. One comprises the stipulations and restrictions contained in the specific trust instrument, will, or agency agreement. The other consists of the guidelines emanating from the "prudent man rule" that, in one form or another, must be followed for trustee accounts in forty-five of the fifty states. This rule requires, in essence, that a trustee make investments "only in such securities as would be acquired by prudent men of discretion and intelligence in such matters who are seeking a reasonable income and the preservation of their capital".[10] Legislation is being considered at the national level to provide for explicit imposition of the rule for all employee benefit fund administrators.

Even when a trust instrument gives a bank great freedom of investment decision, the bank must be guided by the prudent man rule. The rule itself leaves a great deal of room for interpretation, as attested to by conflicting court opinions in past decades concerning the permissibility of investing trust funds in corporate equities. In most states where the rule is incorporated into legislation, it is "permissive" in nature, being in fact only a general guideline. A few states, however, still have a "strict" or "mandatory" rule; investment boundaries are spelled out in terms of kinds of investments, and quantitative limitations are imposed on certain of these investments.

The prudent man rule confronts a bank with simultaneous responsibilities and challenges in requiring the bank to preserve the capital entrusted to it and to employ

Chart II

GROWTH OF FIDUCIARY ASSETS BY TYPE OF ACCOUNT



Notes: Data based on market values. Through 1966, figures are estimates.
*Managing agency accounts were included with the personal trusts and estates data in 1964 and 1965.

Sources: See Table II.

[10] This is the wording of the rule used in the statutes of a number of states. In three states there are no trust investment regulations, and in two states regulations limit investments by trustees to fixed-income securities.

these funds in such a way as to produce the best return obtainable with safety.[11] Within the past few years, the latter objective has come increasingly to the fore. This development was initially stimulated by the demands for greater yields made by corporations that had established pension plan trusts. However, growing numbers of individuals who have agency accounts or who are beneficiaries of personal trusts have been making similar demands.

PERSONAL TRUST FUNDS. Personal trust funds constituted about 42 percent of the fiduciary assets at commercial banks in 1970,[12] a larger share than any other category, although the banks probably do not hold much more than half of all such accounts and a roughly similar portion of all such assets.[13] While the banks' sole corporate competitors for these funds are the approximately fifty nondeposit trust companies (only two of which are sizable) that still exist in the United States, persons establishing trusts very often choose individuals as the trustees—usually attorneys, relatives, or friends.

In investing personal trust funds, a bank must conform with all the stipulations and restrictions contained in the individual trust instrument. Occasionally the instrument limits investments to certain types or prescribed percentages of securities, or to specific issues of a named concern, and if the bank invests in securities that do not conform with these specifications, it may be liable for any losses incurred. The wider the freedom of choice regarding investment decisions given to the bank as trustee, the more must the bank rely for guidance upon the prudent man rule. In a few states, investments for so-called legal trusts must conform with the "legal list" issued in each state for the guidance of fiduciaries. These often limit the percentage of an account that can be invested in common stocks (50 percent is the maximum in some states) and specify which types of equities are acceptable. The number of such trusts has trended steadily downward, however. In 1969, only 5 percent of the personal trust accounts (and 4 percent of such assets) at fifty large banks surveyed for a special Securities and Exchange Commission (SEC) study was subject to legal lists.[14]

The portion invested in equities for accounts where the trustee has complete investment discretion has generally been much higher during the last two decades than 50 percent. During the 1950's, it was a common practice for banks to maintain guidelines limiting investment in equities to about 60 percent of the value of a personal trust. A survey by the American Bankers Association indicated that in 1958 common stocks accounted for about 62 percent of all bank-administered personal trust assets. By 1968, however, the figure had risen to approximately 70 percent (see Chart III), while at banks with trust assets of more than $1 billion the share was almost 74 percent. Some of the particularly aggressive institutions had instituted policies designed to raise ratios still higher, and some trusts at the largest banks were fully invested in equities. Toward the close of 1970, following the prolonged 1969-70 bear market, the equities portion at all banks had declined to 66½ percent, and at the large banks, which altogether held 57 percent of all personal trust assets, it was down to about 70 percent. However, at some of these big banks the proportion of stocks in personal trust funds over which the banks had sole investment authority still averaged between 70 and 80 percent.

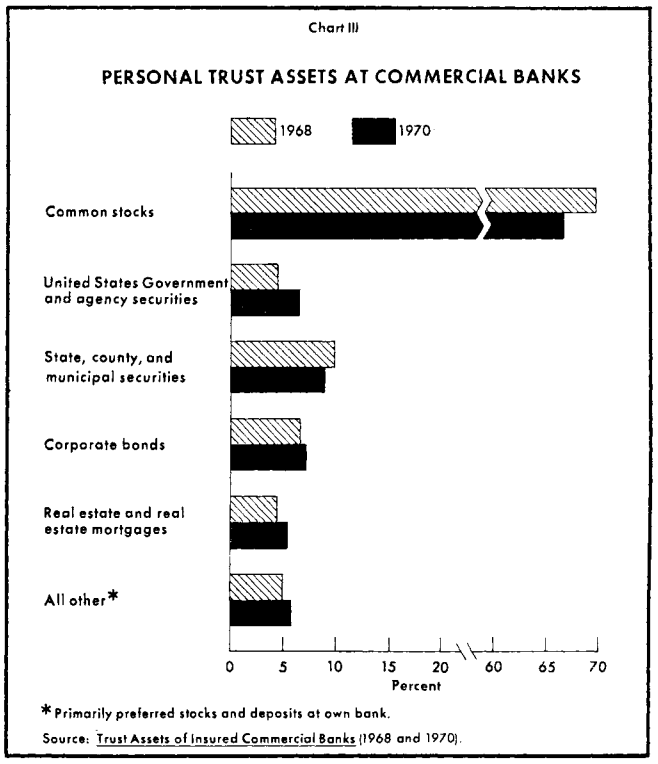
In earlier years, banks had tended to set up investment guidelines in terms of such broad asset categories as common stocks and fixed-income securities, the amounts being determined in accordance with the goals of the trust and the needs of the various beneficiaries. For the past several

[11] The American Institute of Banking put the issue into sharp focus in a 1954 publication, *Trust Department Services: Trusts I.*
"A trustee is responsible for making such investments as a prudent man would make for his own property, having primarily in view the preservation of the estate and the amount and regularity of the income to be derived. In retaining or in selecting investments, a trustee may exercise the caution a prudent man would exercise when a primary consideration is preservation of the funds invested.
The trust institution, however, not only would fail to perform its duty but would soon lose its trust business if it failed to employ the trust property in such a way as to produce the best return obtainable with safety under the conditions prevailing at the time and within the restrictions imposed by the law and by the trust instrument. This is indeed a heavy responsibility, but frequently (perhaps usually) it is a chief object to the creator of the trust. Accomplishment of this result is a service which the trustee represents itself as being able and willing to render; it is a definite undertaking from which the trustee cannot retreat."

[12] The 42 percent represents the sum of 37.7 percent, reported as "personal trusts", and 4.2 percent, the portion of the reported "personal trusts and estates" figure obtained by applying to the latter the share of the total of reported "personal trusts" and reported "estates" represented by "personal trusts".

[13] According to a special analysis by the Internal Revenue Service, 61 percent of the personal trusts that filed income tax returns for 1962 was administered by banks and trust companies. These trusts accounted for 60 percent of the total income received. The United States Treasury Department, Internal Revenue Service, *Fiduciary, Gift, and Estate Tax Returns* (filed during calendar year 1963).

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



years, the emphasis has been more on the specific nature of the stocks and bonds, with guidelines characterizing stocks as "defensive" stocks, "quality growth" stocks, "special situation" stocks, and stocks of companies with "outstanding technical competence". If the income beneficiary of a trust is, for example, a widow who must live on the income of the trust, "defensive" securities may be considered most desirable, but if the income beneficiary is a business executive earning a very large salary, "growth" stocks may be purchased. As a consequence, equities holdings cover a much broader range than previously.

Because of the increasing demand by trust beneficiaries for "investment performance", some banks have begun to ask their customers to redefine their investment objectives in more specific terms than the banks previously requested. If customers insist and can afford the risk, and if the trust instrument provides wide enough investment latitude, or if written approval is obtained, investments will be made, usually to a maximum of 10 percent, in special situation or other high-risk stocks.

The proportion of stocks held for personal trusts at the smallest banks toward the end of 1970 was much less than at the largest banks (44 percent as against 70 percent), and the percentages increased with each step upward in bank-size group (see Chart IV). These differences were presumably attributable at least in part to the progressively larger size of accounts as bank size increases. In 1970, the average personal trust account at banks with less than $10 million in fiduciary funds was only $36,000.[15] At banks with fiduciary funds of more than $1 billion, the average account was approximately eight times larger, amounting to $300,000. Part of the wide spread in the equities proportions, however, probably reflects a difference in investment expertise.

At the smaller banks, and implicitly for the smaller accounts, the investments other than common stocks include two categories of assets that are quite sizable. Holdings of United States Government securities accounted in 1970 for between 8 and 15 percent of total portfolios at the three groups of smallest size banks, and real estate and real estate mortgages (the former valued at more than twice the latter) accounted for between 12 and 18 percent. At the larger banks, holdings of tax exempts are a more important category, presumably reflecting the fact that these banks have many very sizable accounts whose beneficiaries can derive tax benefits from such holdings. Interestingly, corporate bonds, which are the second largest type of investment for employee benefit accounts, are of only minor significance for personal trust accounts, no matter what the size of the bank.

As with stockholdings, a step-like progression by bank-size group was very much in evidence also for the other types of assets. The two major exceptions, the portfolios of United States Government securities and of corporate bonds at the second largest bank-size group, look suspiciously as if they may reflect data-collection problems. Not only do the figures interrupt the relatively smooth sequence shown by other data on Chart IV, but they are equally out of step as indicators of year-to-year fluctuations in portfolio composition, evident on Chart V.

The share of personal trust assets held in common stocks declined between 1968 and 1970 at all six size groups of banks, perhaps partly reflecting the distribution of assets in new accounts. At the second and third largest of the size groups, the net decline was very small (see Chart V), suggesting that fairly sizable purchases had been made even during the bear market, but at banks holding fiduciary assets of more than $1 billion, the net decline was one of the largest registered (4 percent).

[15] At least one bank has publicized its willingness to accept accounts of as little as $5,000.

It would be of considerable interest to know how liquid asset holdings changed during the 1968-70 period. The data available are not sufficiently detailed to give a complete picture, but they do seem to indicate significant growth. Additions to the Treasury bill holdings probably constituted the principal increase. In the comprehensive trust department data gathered by the regulatory agencies, such holdings are not separated out from longer term Government securities. Despite the sharp drop in Government bond prices between 1968 and 1970, total holdings of Government securities rose at all but one of the size groups of banks, and primarily at the larger bank-size groups (see Chart V). Detailed data on pooled trust funds (discussed in the following section) show that almost all of a very substantial 1968-70 increase in Government securities held by these funds consisted of Treasury bills. This suggests that most of the rise in total personal trust fund holdings of Government securities also represented Treasury bills.

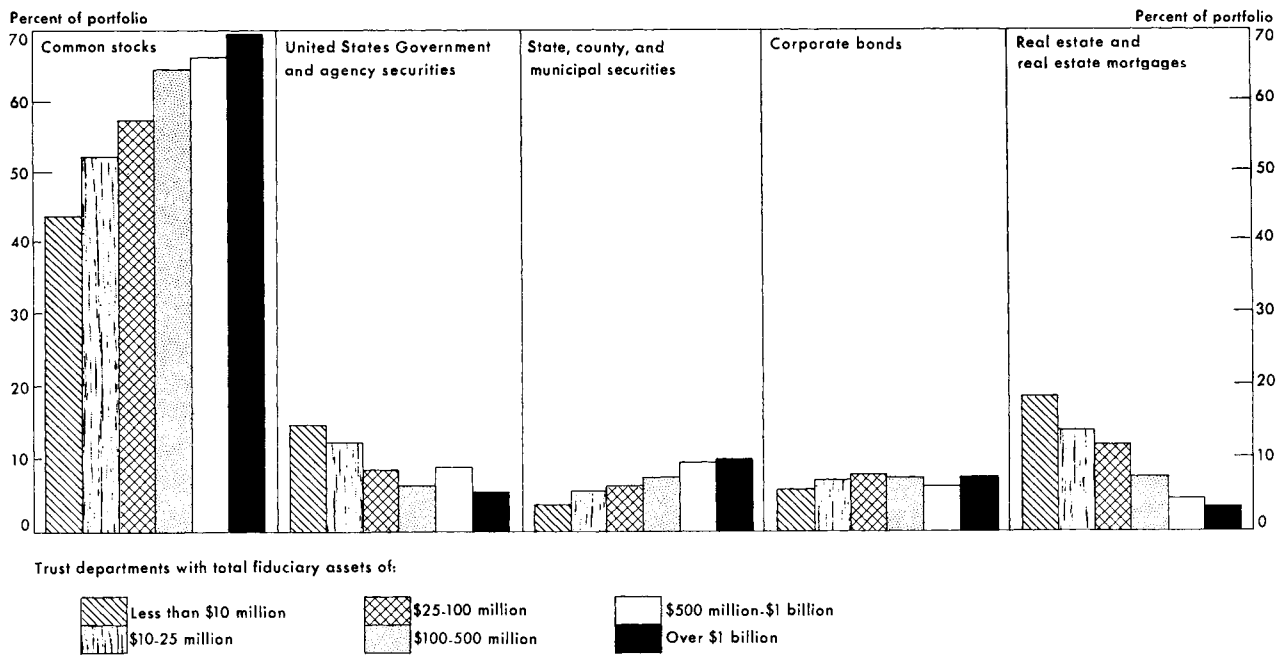
Other liquid holdings are contained within a group of assets that the regulatory agencies asked the banks to report as one "miscellaneous" figure. Included are commercial paper, master notes (a variant of commercial paper described below), and unsecured notes, as well as various nonliquid items.[16] While the miscellaneous figure was not substantial for any group of banks during 1968-70, the share it comprised of total personal trust funds increased for every size group in both 1969 and 1970. These increases were most likely attributable primarily to the liquid components, with the information available for pooled accounts pointing to a rise principally in commercial paper and master notes.

In addition to the above income-earning investments, some portion of personal trust funds is always maintained by each trust department in the form of deposits at its own bank, all but an insignificant amount in noninterest-bearing deposits. These deposits represent undistributed and uninvested principal, undistributed and

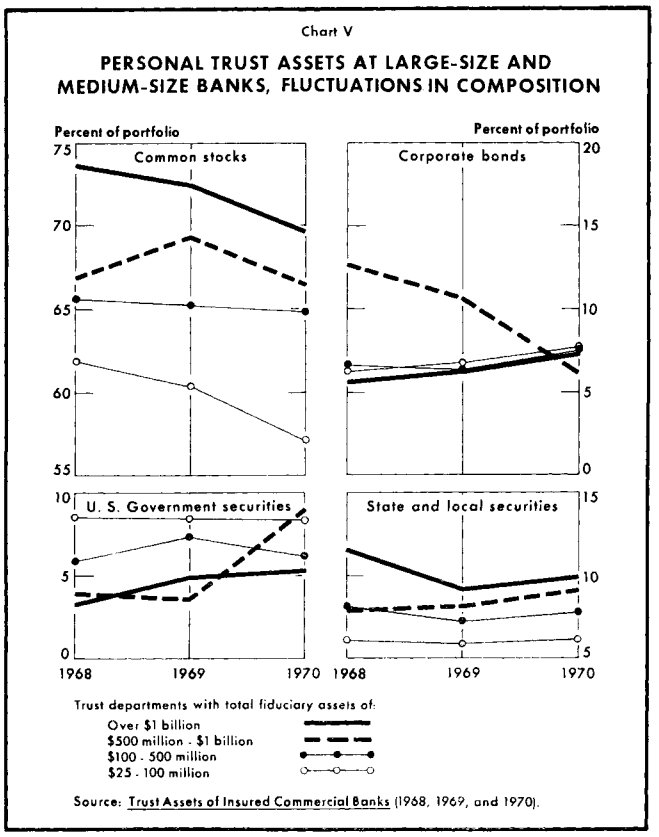
[16] These constitute, mainly, notes secured by other than real estate, judgments, accounts receivable, jewelry, automobiles, and livestock.

Chart IV

PRINCIPAL ASSETS OF PERSONAL TRUST FUNDS, BY SIZE OF TRUST DEPARTMENT, 1970



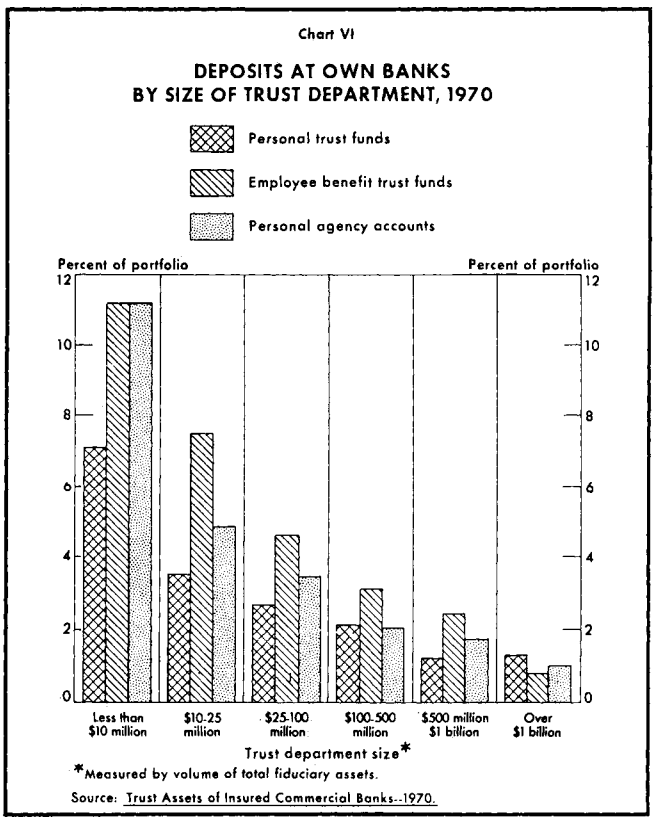
Source: Trust Assets of Insured Commercial Banks--1970.



uninvested income, and, in many instances, "float" connected with securities transactions. Chart VI shows that the portion of personal trust fund assets held in this form in 1970 decreased with each step upward in bank-size group—except at the very largest banks, where the share rose slightly. The portions had increased between 1968 and 1970 at all of the six groups of banks but the second largest size group. The biggest gain, 0.9 percent, occurred at the smallest banks. At the largest banks, the rise was only 0.4 percent, but this expanded the portion held in deposits by almost 50 percent. Prior to the 1969 and 1970 increases, the share held at this group of banks had been smaller than at the size group below.

Common trust funds. A small percentage of the approximately $122 billion of personal trust assets is held in common trust funds. Banks have been pooling in common trust funds some funds from smaller personal trust accounts since the 1930's, in an effort to reduce the costs of managing small funds and also to permit wider diversification of investments for such funds. In more recent years, to improve investment flexibility, "single purpose funds" have been developed. All states now have statutes that authorize personal trust funds to be put into a pool if the trust instrument for a particular account does not prohibit it and if all the investments of the pool are appropriate for investment by each participating account. The funds must be administered in accordance with regulations established by state banking authorities and with Regulation 9 of the Office of the Comptroller of the Currency. Since the results achieved by these funds are made public each year by the Comptroller, many banks regard them as showpieces for their personal trust activities.

By the end of 1970, common trust funds had been established by 692 banks, approximately one fifth of the banks that conduct trust operations. The total number of these funds—1,678—was almost 2½ times the number seven years earlier, when the Comptroller removed the $100,000 ceiling that had previously limited each participation. Currently, aside from any limitations that may be imposed by state laws, the only legal constraint on the amount that can be placed in a common trust fund for any individual trust account is a provision that no participating account may hold more than 10 percent of a common trust



fund's total assets. Total common trust fund assets at the end of 1970 amounted to $10.1 billion, equal to 9.3 percent of all personal trust account assets and encompassing close to 412,000 participations. (If one account is invested in more than one fund, this counts as more than one participation.) Most of the funds were at the smaller banks, but a major portion of the assets was at the larger banks.[17] This was in part a result of the difference in the size of the participations; the average was only $12,000 at banks with commercial banking assets of less than $100 million, while at banks with assets of $1 billion or more, the average participation was $36,000. Of course, many participations are much larger. Indeed, some of the big banks aim at placing in common trust funds any personal trust account with assets totaling less than $250,000.

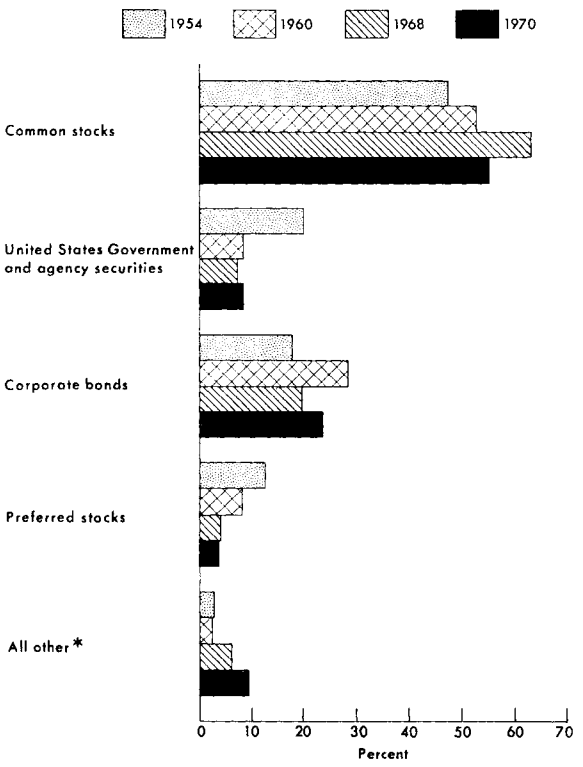
There are four broad categories of common trust funds: diversified or balanced, equity, fixed income, and tax exempt. Some funds are very specialized, consisting, for example, of only corporate bonds, "growth" stocks, "income" stocks, real estate mortgages, or "legal" investments. Prior to 1970, diversified funds held more assets than any other type of common trust fund, but at the end of 1970, equity fund assets (accounting for 31 percent of the total) slightly exceeded diversified fund assets for the first time. Tax-exempt fund assets amounted to only 21 percent of the aggregate, but this was somewhat more than the assets held by fixed-income funds.

Even though diversified common trust fund assets at the end of 1970 constituted less than 3 percent of the banks' total holdings of personal trust assets, it is worth examining the changing composition of these diversified funds during the preceding two decades. Detailed data for individual personal trusts do not reach back that far, but the developments in diversified fund portfolios are probably indicative of changes that occurred in banks' investment policies for personal trusts. As can be seen on Chart VII, in 1954 common stocks accounted for 47 percent of diversified fund portfolios, while holdings of United States Government bonds, representing 20 percent, were also quite significant. By 1968, however, common stocks had risen to almost two thirds of the portfolio, and Government securities had fallen to a mere 7 percent. Preferred stocks, which had been the fourth largest component in 1954, also slipped sharply. Corporate bonds, on the other hand, despite only a small increase, rose from third place to second place. Between 1968 and 1970 (when direct comparisons can be made with total personal trust account assets), component movements were generally in the same direction for total personal trust accounts as for diversified common trust funds.

EMPLOYEE BENEFIT TRUST FUNDS. Employee benefit trust funds accounted for 32 percent of the banks' fiduciary assets in 1970, and it is estimated that all but about one tenth of this consisted of pension funds. Total private noninsured pension funds in the country represented

Chart VII

ASSETS OF DIVERSIFIED COMMON TRUST FUNDS



*In 1970, primarily private placements, state and local bonds, mortgages, and commercial paper.

Sources: Federal Reserve Bulletin; S. Silverberg, "Bank Trust Investments", The National Banking Review (June 1964); and Office of the Comptroller of the Currency.

[17] Banks too small to find it feasible to set up common trust funds have the possibility in three states of investing fiduciary funds in an investment company organized for the specific purpose of pooling funds held by corporate fiduciaries. In New York and Ohio the respective state banking associations have organized such companies under specific authority granted by state legislation. In Georgia, legislation enacted only two years ago granted such authority to private banks. The Congress is currently considering legislation that would further broaden the opportunities for pooling, by explicitly permitting banks affiliated with one another to contribute in their fiduciary capacities to a common trust fund maintained by one of the banks for the entire group.

a pool of assets at the end of 1970 with a market value of $105 billion. By the end of 1971, the figure had risen to $125 billion. In view of this massive volume of funds already accumulated and their anticipated further growth, it is not surprising that there exists intense competition for the management of these funds. Banks apparently still hold about four fifths of the total (pension funds probably accounted for approximately $84 billion of the trust assets held by banks in 1970), but an increasing number of corporations are choosing nonbank managers.[18] A 1971 survey covering 714 companies found that in 1965 as many as 75 percent of these companies had had pension plans managed by banks, but by 1970, despite a growth in the total number of plans (some companies had more than one), only 68 percent had plans managed by banks. Life insurance companies, which had been pioneers in corporate pension fund management during the 1930's, had also lost ground, the comparable percentages declining from 38 percent to 35 percent. Over the same period, the number of companies using independent investment counselors as fund managers had increased from 5 percent to 22 percent; those using brokerage houses, from 1 percent to 8 percent; and those using open-end investment companies, from 1 percent to 3 percent.[19]

One reason banks still hold about 80 percent of private noninsured pension fund assets is that they have managed to retain a very high proportion of the largest funds. Among the 714 companies referred to above, pension trusts of $50 million or over had total assets in 1970 of $50 billion (89 percent of the $56 billion of noninsured assets encompassed by the survey), and banks were the managers for the overwhelming majority of these accounts. However, the survey provided strong evidence of the growing tendency, particularly among the bigger business firms, to seek greater diversity of management.

This increased mobility of pension funds reflects the heightened desire to obtain a better return on pension fund investments as measured by, primarily, capital appreciation. It has been estimated that by improving the annual yield on pension fund assets by even ¼ percentage point, an investment manager enables a corporation to reduce the costs of a pension plan by 4 to 6 percent a year.[20] It is no wonder, then, that with alternative investment managers increasingly available, corporate treasurers have become much more willing to switch managers and are using various means to spur them to better performance. There has been, for example, a rapid growth in the number of firms that parcel out pension funds to several managers and review performance results every few months. Many of these firms are, in addition, informing managers of the better achievements of others. Sometimes managers who are regarded as disappointing are being dropped after only two or three years.

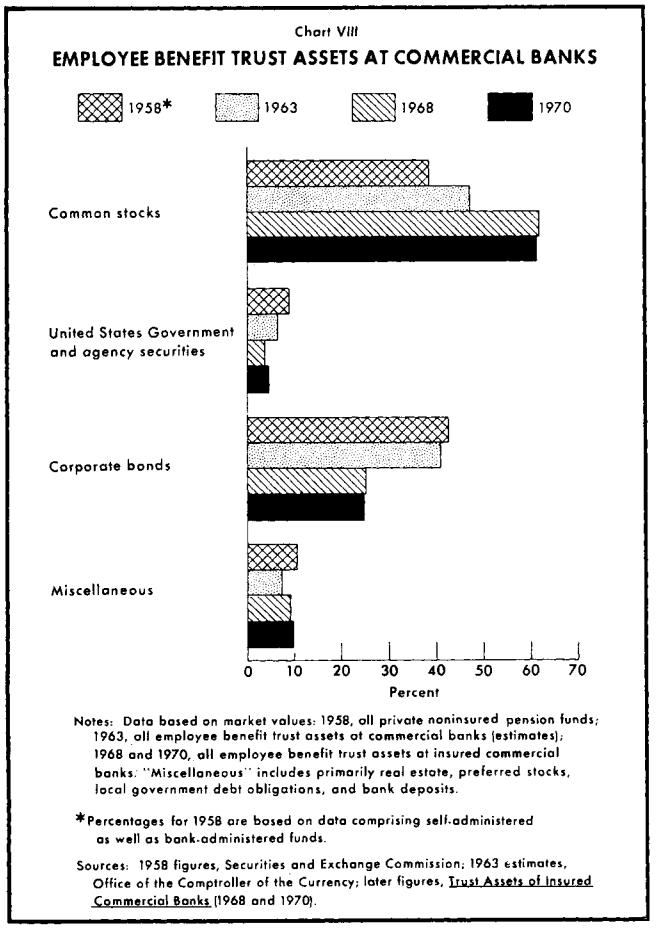
Partly in response to the intense competitive pressures and partly because of a considerable transformation during the past two decades in pension fund investment philosophy, the composition of pension fund assets has undergone dramatic change. Initially, pension fund investments had been guided by a sinking fund type of calculation, based on the concept that a specific rate of earnings was required to enable future fixed liabilities to be met. Eventually, however, it became a general assumption that benefits would be undergoing adjustment to allow for increases in the cost of living as well as for other developments, and that as a consequence it was impossible to know exactly what payouts would be required in any future year. Therefore, the goal now is to employ pension funds as productively as possible on a long-range basis.

Since the 1950's, the asset composition of pension funds has shifted heavily from fixed-income securities to equities. In 1958 (the first year for which detailed data are available), common stocks accounted for only 39 percent of the market value of all private noninsured pension funds (see Chart VIII); the figure for bank-managed funds alone was probably somewhat less. By 1963 (the first year for which reliable trust department estimates are available), the proportion of bank-managed employee benefit trust funds in equities had risen to 47 percent (and that for all private noninsured pension funds to 49 percent). By 1968, there had occurred a further jump to 62 per-

[18] A 1970 survey of 675 of the country's largest nonfinancial corporations found that at the beginning of the 1960's these companies had decided in favor of banks 67 percent of the time when choosing new pension fund managers; in 1969-70, however, they chose banks in only 39 percent of the cases. Louis Harris and Associates, Inc., *Large Corporations and Their Pension Funds: 1970* (New York, 1971).

[19] These percentages total more than 100, owing to the use by some firms of more than one type of manager. McGraw-Hill Publications Company and Standard & Poor's/InterCapital, Inc., *Pension Fund Management Survey* (September 10, 1971).

[20] To maintain a pension plan in accordance with actuarial principles requires current recognition of the accruing costs of commitments for future payouts. Assumptions must therefore be made regarding the level and structure of retirement benefits, mortality rates and trends, employee turnover, years of employee service, ages at which employees will leave, and earnings from fund investments. In many cases, corporations vary their pension fund contributions from year to year as a technique for averaging corporate income.



cent. Over this same ten-year period, the share of bank-managed assets in the major types of fixed-income investments, namely, United States Government securities and corporate bonds, had plunged from more than 50 percent to only 29 percent. As the chart shows, asset composition at the end of 1970 was little changed from the 1968 distribution. The percentage of portfolio in common stocks decreased slightly, owing mainly to the decline in equities prices that lasted throughout 1969 and well into 1970. The share held in corporate bonds continued to contract, but the decline was very small. Meanwhile, the share consisting of Government securities rose slightly, as did the share of miscellaneous assets.

Three banks accounted for over one third of the $93 billion of employee benefit trust funds managed by banks in 1970, and just twenty-two banks (almost all of which held employee benefit assets in excess of $1 billion) accounted for fully 75 percent. This was a significantly greater concentration than characterized trust departments' other fiduciary holdings (see Chart IX). Because of this heavy concentration, the composition of employee benefit trust assets held at these large banks dominates the allocation of total employee benefit trust assets shown on Chart VIII.

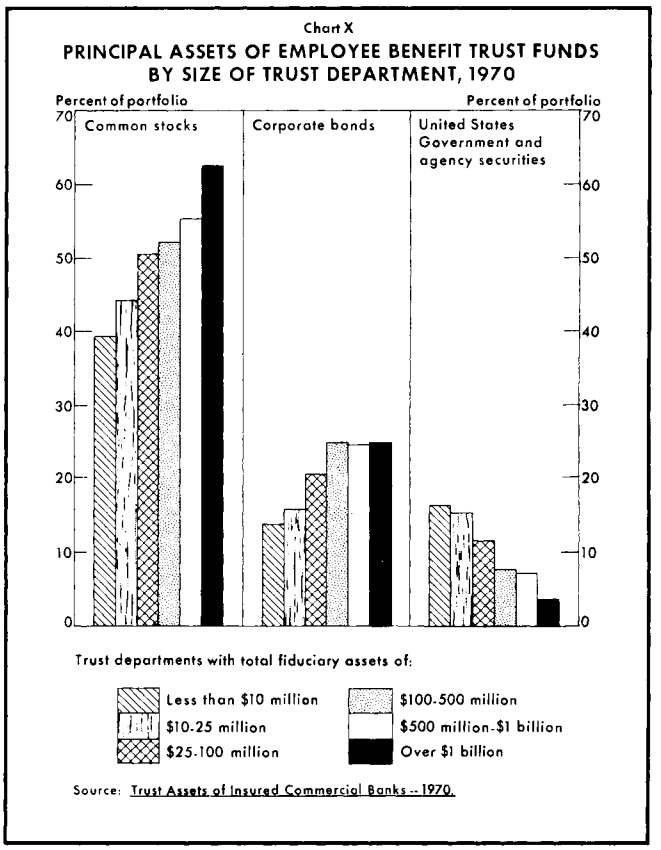
As with personal trust assets, there is a distinct relationship between the size of a trust department and the employee benefit trust investments at that department. Chart X exhibits an almost uninterrupted step-like movement, the direction depending upon the type of asset. Toward the end of 1970, only 39 percent of the employee benefit trust assets at the smallest departments was invested in common stocks; at the biggest departments the proportion was more than half again as large. Similarly, holdings of corporate and other non-Government bonds amounted to 14 percent at the smallest departments, while the proportion at the biggest departments was almost twice this figure. In contrast, assets invested in United States Government and agency securities accounted for 16 percent at the smaller departments, four times the percentage reported for the biggest departments.

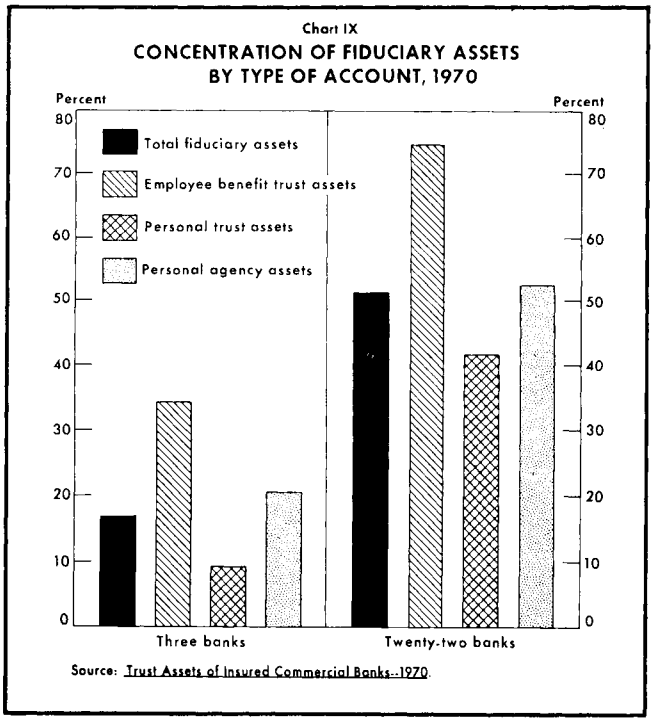
The wide disparity in asset composition as between funds held by smaller banks and those held by larger banks is probably attributable in substantial measure to two factors. The first reflects the fact that bank trustees must make allowance for the specific requirements of individual accounts. Since the employee benefit fund accounts at smaller banks are generally those of smaller firms, the principle of minimum risk investment is probably deemed advisable for most of the accounts. A pension plan for the employees of a large corporation that is well established and that presumably could meet pension plan requirements under prolonged adverse business conditions can be invested more "liberally"—that is, with greater short-run risk taking—than the funds for a plan set up by a smaller firm. Moreover, if a corporation maintains a profit-sharing plan but no pension plan, which is often the case for smaller firms, investments are generally more conservative than when a profit-sharing plan is coupled with a pension plan, as at many larger firms. The second factor accounting for the disparity in asset composition is the more limited degree of investment expertise at the smaller banks.

Although the shift by bank trustees to equity investments was rather slow in the fifties and early sixties, the dramatic performance of many mutual funds during the second half of the sixties precipitated a demand by corporate executives for an improvement in bank trustee performance beyond the 6 to 7 percent previously regarded as a good return. This stimulated a more rapid shift, and

by 1968 apparently a majority of the large banks were regarding 60 to 65 percent as an appropriate equities allocation for the bulk of their pension fund accounts. A number of the banks, however, were aiming for 80 percent for most of their accounts and some even for 100 percent for the biggest accounts. In 1969, at banks that held total fiduciary assets of more than $1 billion each, the proportion of employee benefit trust assets in equities rose slightly, measured at market value, despite the widespread extended decline in stock market prices—suggesting that many of the banks made net purchases of common stocks that year. In 1970, the percentage fell back to the 1968 level (see Chart XI). At banks with fiduciary assets of between $500 million and $1 billion, there was a rather similar development—a rise in 1969 and a decline the following year, but to a percentage even lower than in 1968. Banks comprising the next two smaller size groups, however, showed declines in both 1969 and 1970.

At the close of 1970, the goal at the larger banks for the proportion of employee benefit funds typically to be held in equities seems still to have varied within almost the same broad range as two years earlier. Moreover, 42 percent of 675 large corporations covered in a survey taken in the late summer of 1970 expected to have between 70 percent and 100 percent of their pension fund assets in equities in 1975, a substantial increase over the 33 percent already reporting such large proportions.[21]





As with equity holdings, during the two years ended 1970 the proportions of corporate bonds in the employee benefit fund portfolios of the two groups of banks with the largest trust departments again showed almost parallel movements (see Chart XI). In 1969, when bond yields were rising steeply and prices falling sharply, there was only a small percentage decline (measured at market prices) for each of the two groups of banks, suggesting there might have been some shifting into this type of asset when yields seemed attractive. During 1970, when prices rose somewhat and yields fell, there was only a slight percentage rise for each group, seeming to indicate there was little interest in adding to this type of asset that year. At the two medium-size groups of banks, however, the shifts into corporate bonds were quite substantial over

[21] Louis Harris and Associates, Inc., *op. cit.*

the two-year period, roughly offsetting the declines in equity holdings.

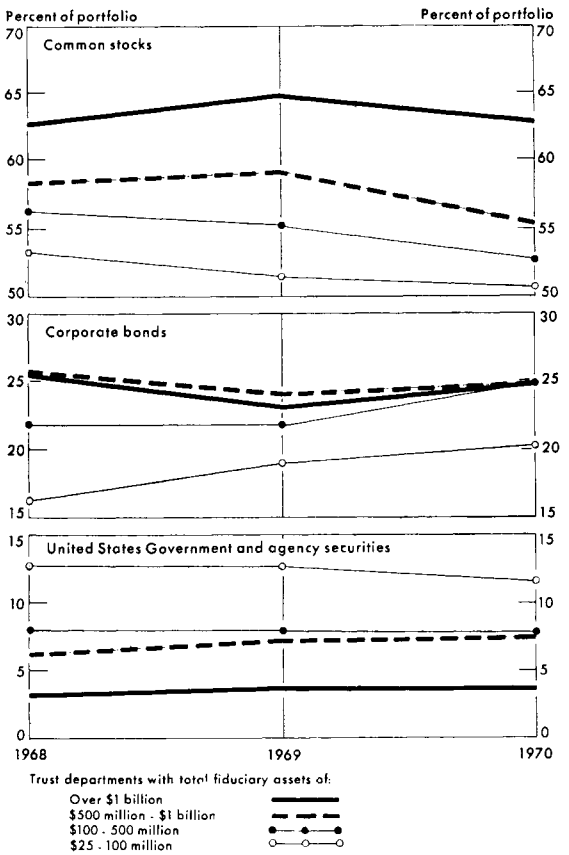
The variations in portfolio percentages in United States Government and agency securities were, in general, considerably smaller than the fluctuations in percentages held in equities and corporate bonds. Nonetheless, the patterns at the two largest size groups of banks were again quite similar to each other, with the data suggesting relatively sizable purchases in 1969. At both groups of medium-size banks, however, and at one of the two small-size bank groups, there was some decline over the two-year period. Still, since this was a period when Government bond prices dropped sharply, small percentage declines do not rule out the possibility that additions were made to Government securities portfolios. It seems likely there was a widespread buildup of Treasury bill holdings for liquidity purposes.

While banks differ in their choices of short-term liquid instruments for employee benefit accounts, among those favored during the past decade, in addition to United States Treasury bills, were Federal agency obligations and commercial paper of finance and other companies. Around 1965, however, the master note (also known as demand note, variable amount note, or credit arrangement) was introduced as a new short-term investment vehicle, and it has become very popular as a temporary investment. The master note enables credit to be made available through direct negotiation by the trust department, usually to a nationally known finance or industrial corporation that is a customer of the bank. The trust department agrees to lend to the borrowing corporation either a specific or a maximum amount, for either a given period of time or on a day-to-day basis. The interest rate on the master note is usually, perhaps always, the going rate on the borrower's 180-day commercial paper. Many trust departments apparently regard these notes as a means for earning the highest yield possible on a short-term basis and consider them more liquid than Treasury bills. The notes are for large amounts and are participated among many accounts. Probably investments in master notes account for most of the rise that occurred between 1968 and 1970 at five of the six size groups of banks in the miscellaneous figure that is a component of the employee benefit funds data collected by the regulatory agencies. Master notes and Treasury bills presumably comprised the bulk of the accumulation of liquid assets for employee benefit funds at the larger banks. On occasions during the past few years when investment officers at these banks have taken a cautious view of the stock market, the liquid component of some accounts has risen as high as 15, 20, or even 30 percent.

The share of employee benefit fund assets in deposits in own bank increased between 1968 and 1970 at every group of banks except the largest size group. The percentage held in such deposits declined significantly with each step upward in bank-size group (see Chart VI). At the smallest size group, deposits accounted in 1970 for more than 11 percent, compared with less than 1 percent at the largest size group. There probably are several reasons for this substantial spread. First, it is more difficult for banks with relatively small balances to find investment outlets for short periods. Second, the pressure from corporate managements for better performance for pension fund trusts is presumably greater at the bigger banks than at the smaller ones, since the former hold the funds of the larger enterprises with the most sophisticated financial officers. Third, the big banks may well be more sensitive than

Chart XI

EMPLOYEE BENEFIT TRUST ASSETS AT LARGE-SIZE AND MEDIUM-SIZE BANKS, FLUCTUATIONS IN COMPOSITION



Source: Trust Assets of Insured Commercial Banks (1968, 1969, and 1970).

smaller banks to competition for the management of the pension funds. Finally, the big banks have the greater expertise, manpower, contacts, and machinery for putting funds to the most productive use quickly, even for short periods of time. The share of employee benefit funds portfolio in deposits at five of the bank groups is significantly higher than the share of personal trust accounts, presumably reflecting mainly the relatively larger amounts disbursed as payments to pension fund beneficiaries. However, at the largest banks the employee benefit deposit share is lower than that for personal trust funds. This probably attests to the banks' efficiency in handling short-term investments.

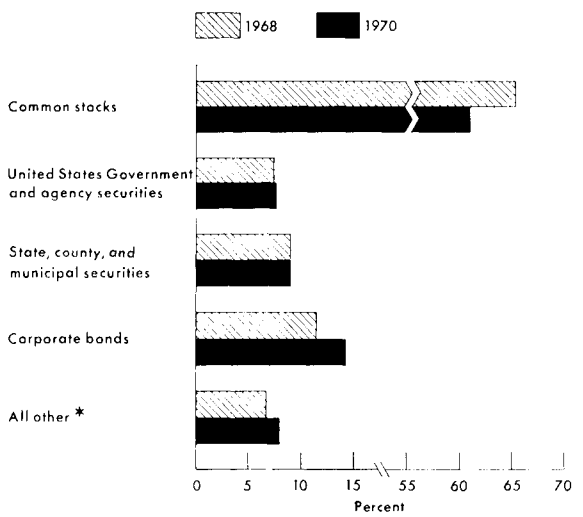
Commingled funds. A significant portion of the employee benefit trust assets is held in commingled funds. During the 1950's, in order to reduce administrative costs, banks began establishing such funds, in which they pooled the assets from small pension and other kinds of small employee benefit trusts. Today, the large banks have many specialized commingled funds, and an account may be split among two or more of them. The assets of some of these commingled funds may carry above-average risk—for example, "special situation" funds, which invest in securities offering unusual growth possibilities. These more speculative funds are designed primarily for the pension trusts of large corporations, with bank policy often limiting investment to a certain percentage of an individual pension trust. Other special commingled funds may consist of fixed-income securities only (sometimes a bank has one fund for short-term securities and another for long-term securities) or of equities only (sometimes including convertible issues as well). Generally, a bank places a limit on the percentage of a commingled fund that can be held by an individual trust (usually 5 or 10 percent).

Since pooling operations reduce costs considerably, many banks charge lower management fees, particularly for smaller accounts, when a customer agrees to have a trust account invested entirely in commingled funds. The earlier-mentioned SEC survey of fifty large banks found, for example, that almost half of the banks reduced the minimum fee charged pension fund accounts by almost 75 percent if all the assets were allowed to be commingled. At the rates that prevailed in 1969, this saved the small business firms that were affected over $800 a year, on average. Big banks generally prefer to invest in commingled accounts the entire assets of as large a number as possible of their accounts of less than $1 million. Indeed, the very biggest banks have a guideline of as high as $1½ million or even of several million. As a result, it is not uncommon for most of the employee benefit trust accounts at such banks to be wholly or partially invested in commingled funds. In dollar terms this has worked out in the last few years to between 10 and 20 percent of total employee benefit trust fund assets. At the fifty banks surveyed by the SEC, more than half of the total assets of the employee benefit trusts that had less than $500,000 each was invested in commingled funds in 1969. For the next larger size group (pension funds ranging from $500,000 to $1 million), the figure was 31 percent. However, for funds of a size between $100 million and $500 million, the proportion dropped to as low as 3 percent.

PERSONAL AGENCY ACCOUNTS. Nearly one fifth of the fiduciary assets in banks at the end of 1970 was for personal agency accounts. The concentration of agency assets was considerably greater (20 percent at just three banks) than that of personal trust assets (see Chart IX). The banks, which rival with investment counselors for agency accounts, have felt increasing pressure from agency customers during the last few years to show improved performance. Previously, most banks had sold personal agency services as they had personal trust services, expounding on their long-term achievements. Since the late 1960's, however, many customers have wanted to see short-term results each year.

There is generally more variability in investment policy among the agency accounts than among the trust accounts

Chart XII
PERSONAL AGENCY ASSETS AT COMMERCIAL BANKS



*Primarily preferred stocks, deposits at own bank, and real estate.
Source: Trust Assets of Insured Commercial Banks (1968 and 1970).

at any one bank. The majority of the agency accounts do not accord the banks sole investment responsibility; consequently, the specific desires and requests of agency principals are unusually important in determining the makeup of the portfolios. Aggregate data show a lower percentage of common stocks in agency accounts than in trust accounts (see Charts XII and III), even though at some of the big banks most agency accounts reportedly are invested more heavily in common stocks than are most trust accounts. A somewhat larger drop was registered between 1968 and 1970 for agency holdings of equities than was the case for trust holdings. Perhaps this reflected the fact that often a larger percentage of the equities investments of agency accounts had been in "growth" stocks, "special situation" stocks, and other securities that underwent particularly sharp price declines during the 1969-70 bear market.

Considerable differences between agency and trust portfolios are apparent also for other components. In 1970, corporate bonds were roughly twice as important in agency portfolios as in trust portfolios, and the agency share rose much more sharply between 1968 and 1970 than did the trust share. The proportion of total agency portfolios in real estate and real estate mortgages, on the other hand, was less than half that shown for trust holdings.

The sizable 1968-70 decline in agency stockholdings was shared in by every size group of bank, and developed year by year except at banks with fiduciary assets of more than $1 billion. At the latter, there was a slight increase in 1969, apparently reflecting both an inflow of new agency funds and also net investments despite the widespread decline in stock prices; this was followed, however, by a sizable decrease in 1970. The substantial 1968-70 rise in corporate bond investments was another development common to all size groups of banks. An advance was also recorded at each group of banks in the miscellaneous component, with the largest gains occurring mainly in 1969. The increases presumably reflected primarily a buildup of liquidity in the form of commercial paper and master notes.

Deposits held at own bank for personal agency accounts constituted at most groups of banks a somewhat larger share than did deposits for personal trust accounts (see Chart VI). At the smallest banks, the share was very much higher, slightly above 11 percent compared with 7 percent. At the largest banks, however, the relationship between the shares was reversed. At four groups of banks the personal agency account shares were, like the personal trust account shares, lower than the employee benefit trust deposit shares. The situation at the very large banks was again an exception, but there the ratios for all three categories of accounts were quite low.

[*This article will be concluded in a subsequent issue of the* Review.]

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