

## **Fiduciary Trust and Personal Banking**

[http://cba.unomaha.edu/faculty/mohara/web/AEF09\\_FiduciaryTrust\\_&PersonalBanking.pdf](http://cba.unomaha.edu/faculty/mohara/web/AEF09_FiduciaryTrust_&PersonalBanking.pdf)

by

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### **Introduction**

A fiduciary relationship generally consists of two separate and distinct parties connected by a justifiable expectation of trust. The first party is the fiduciary, who is considered the "trustee" in the relationship; and the second party is the principle who is the "beneficiary" of the relationship. As a trustee the fiduciary may be natural person or a mere legal person (e.g., corporation). The trustee is obligated (typically, but not necessarily, by contract) to act on behalf of the beneficiary in a confidential or trust relationship. As such, the fiduciary (certainly can, but) may not put the trustee's personal interest ahead of the beneficiary's interests. Also, the trustee (certainly can, but) may not profit from the fiduciary's transactions as trustee unless the beneficiary [A] has knowledge of, and [B] consents to the trustee's profiteering. If the trust has been breached, then liability typically ensues for the trustee.

With a fiduciary responsibility whether the fiduciary wins or loses turns on how the trustee plays the game. A hint of deception by a trustee can be damning.

### **Who has Fiduciary Responsibility?**

The *Foundation of Fiduciary Studies* describes a fiduciary as a person that:

- 1) Manages assets for the benefit of another;
- 2) Exercises discretionary authority or control over assets,  
and;
- 3) Acts in a professional capacity of trust and renders

comprehensive/continuous investment advice."<sup>4</sup> In the general course of business many representatives are designated as fiduciaries. In the *Financial and Investment Dictionary* a fiduciary is defined as "A person, company or association holding assets in

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<sup>4</sup> Fiduciary360. *Prudent Practices for Investment Stewards*. Edited by James G Busse and Bennett F. Aikin. 2006.

<http://www.fiduciarystore.com/index.asp?PageAction=VIEWPROD&ProdID=28>

trust for a beneficiary".<sup>5</sup> In the theory of finance, the fiduciary is charged with the responsibility of investing money wisely for the beneficiary's benefit. Some examples of fiduciary are executors of wills and estates, receivers in bankruptcy, trustees and those who administer the assets of underage or incompetent beneficiaries. The *Real Estate Dictionary* gives examples of those who act, in a legal role, in the best interest of others;

- 1) "A broker is a fiduciary for the seller.
- 2) A banker is a fiduciary for the bank's depositors.
- 3) An attorney may be a fiduciary for the client.
- 4) A trustee is a fiduciary for the beneficiary."<sup>6</sup>

Note that the second definition from the *Real Estate Dictionary* (i.e., A banker is a fiduciary for the bank's depositors) is the central theme of this paper and somewhat begs our question: What is the scope of the fiduciary relationship between a banker and a client (depositor)? Clearly the bank's client often does assume that a fiduciary relationship with a personal banker is carried forward from the transaction of insured depositor to the transaction of mortgage borrower. But, more exactly, is that assumption by the bank's client a justifiable expectation of trust?

For many years, individuals both financially astute and not have turned to their personal banker for financial advice. Most individuals understood that their bankers were in a position of "trust" with respect to deposits. Many of the less financially astute individuals also believed that their bankers were in a position of "trust" with respect to all other banking transactions. Many of these individuals relied heavily upon a personal banker's opinions.

Clearly, this trust relationship between the financial institution and the client helped financial institutions. Therefore, financial institutions took many affirmative steps to develop and promote the public's and their client's expectations of trust. Trust became especially important when financial institutions were "community" fixtures. Banks employed the "We're part of you." throughout their marketing campaigns, embedding that catch phrase both in their sales pitches and in their promotional advertising. Financial institutions traded on the fiduciary angle. Banks gave minimal lip service (e.g., footnotes stating a transaction is not FDIC insured) to differentiating between clearly fiduciary areas of the bank's business (e.g., FDIC insured deposits) and not necessarily fiduciary areas of the bank's business (e.g., mortgage lending). The advertising campaigns had the effect of co-mingling in the minds of consumers both trust relationships and arm's length business relationships. That co-mingling was good for the bank's reputation. The customers tended to interpret this co-mingling as extending the cloak of fiduciary duties across all of the bank's business transactions with the client. What may the bank's bank justifiably expect in the way of fiduciary trust

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<sup>5</sup> *Dictionary of Finance and Investment Terms*, 7th edition. Edited by John Downes and Jordan Elliot Goodman. Barron's Educational Series, Inc: 2006.  
<http://www.barroneduc.com/0764134167.html>

<sup>6</sup> *Dictionary of Real Estate Terms*, 7th edition. Editors Jack P. Friedman, Jack C. Harris, and J. Bruce Lindeman. Barron's Educational Series, Inc: 2008.  
<http://barroneduc.stores.yahoo.net/0764139363.html>

from the bank? Did the less financially astute clients understand that trust ought be limited to deposits, and that all other banking transactions were at arms' length? Did the left handed footnotes successfully take away what the right handed ad campaigns had appeared to give?

The banks' need to build depositors' trust no doubt increased in importance after the bank failures of the Great Depression. Both banks and government devoted great effort to that task. Individuals were avoiding banks with grave consequences for the entire economy. A classic Tragedy of the Commons followed. In order to dissuade individuals from avoiding banks the government and the financial institutions assured depositors that their money was available on demand at any time, and that their risk of loss on a deposit was zero. To achieve these risk free deposits the depositors needed to perceive the nation's banks as institutions of "higher financial morality". Accordingly, the government created, and the members of the banking system welcomed, regulation of entrance into banking as well as restrictions on banks veering off into financial markets beyond the traditional banking markets. Both by statute and administrative regulations the actions of banks were greatly limited. Once so focused, banks were compelled by market pressures to pay attention to customers' deposits and borrowings because those deposits and borrowings were the bank's primary source of cash flow and profit.

Because bankers are a creative group (contrary to the public's impression of bankers), over time the financial services available from most banks grew in number, size, and diversity. As those available services proliferated so to did the risks to the bank and the opportunities for mischief in a bank's relationships with its clients. The phrase "full-service banking" was adopted as a description of the collection of new banking services and products. In effect, banks became financial services supermarkets.

An expanded array of services invited more advertising that sought to brand each individual bank as a knowledgeable and trustworthy financial supermarket. The minimal public information (e.g., footnotes in newspaper ads and in TV ads) differentiating trust relationships from the financial supermarket were not particularly persuasive. Customers were tempted to see the entire bank as operating under the cloak of fiduciary trust; while at the same time the fine print expressly disclaimed any such notion. The customer was invited to believe "I can trust my personal banker in all aspects of my personal financial business *because* (legally and literally) I can trust my bank with one aspect: my deposits." When the less than financially astute banking client jumps to that conclusion, is that a justifiable expectation of trust?

### **The Agency Problem**

The principal - agent problem exists in every relationship where one party acts for another. Fiduciary relationships are but one type of relationship that can be adversely affected by the principal - agent problem. All agents have some opportunity to take advantage of their principal because the principal's supervision of the agent's actions can not be 100% effective. To some extent, the agent must have discretion that can not be effectively monitored by the principal. Some relationships are prone to particularly large principal - agent problems. For example, the opportunity for abuse is

significant if either asymmetric information (e.g., agent has far greater knowledge than the principal) is present and/or if the agent is empowered to take actions beyond the watchful eyes of the principal. As the informational asymmetry increases and as agent's actions become less transparent, both the risk of the potential consequences of the principal - agent problems increase. Banks tend to possess both advantages relative to their clients. Banks know far more than nearly all of the bank's clients; additionally, nearly all of the banks actions take place within the proverbial black box. Banks have great opportunities to take advantage of their clients by way of the principal - agent problem. Fiduciary relationships then compound the potential for and create the opportunities for specific types of principal - agent problems. Typically, the trustee is unusually well positioned to get away with subjugating the beneficiary's interests to the trustee's interests. In fact, no agent can effectively serve two masters; but, all trustees are legally obligated to specifically avoid that risk.

As a trustee the bank is to serve the client subject to the prevailing financial markets. The profit derived from those services are right and good. In some cases, however, banks will attempt to simultaneously serve their clients interest and the interests of the bank. Some see banks as employing their genuine fiduciary relationships as a lure to entice depositors into ordering additional services and thus making the bank additional profits as the bank serves the bank's interest above the client's interests on those additional transactions. The bank claims these additional transactions are no more than arm's length transactions, pointing out the very clear language in the footnotes. Only when the prevailing market aligns the client's interests in parallel with the interests of the bank can the bank avoid subjugating the client's interests to the bank's interests. And, how often does that happen: if ever? Even the most naive bank customer expects a direct conflict of interest between the depositor and the bank on the question of interest earned on deposits. But, does the average bank customer justifiably expect the degree of conflict inherent in the ordinary mortgage transaction when that mortgage transaction is placed into the context of the fiduciary depository relationship and the bank's marketing campaign built on the perception of trust?

It is not a bold assertion to claim that "community banking" facilitates the perception of trust. In pursuit of financial engineering advantages the idea of "community banking" has been pushed aside in a rush towards corporate banking structures. What then is the relationship between the financial institution and its clients? Does that relationship change when the bank tremendously expands the "community" from which those clients are drawn due to a stand alone "community bank" joining via corporate mergers a banking system? Banks have gone through an extended period of mergers upon mergers. The remaining behemoths have removed much of the "brick and mortar" from each stand alone "community" in the banking system's pursuit of the profits. How does the relationship between client and bank change when the banking system seeks cost reductions by replacing bricks with internet clicks? When the client is an account number appearing as digital stream rather than a real person standing before a teller or sitting before a loan officer, how does justifiable expectation of trust by the customer change?

Financial institutions have been trading on the "trust card" for many decades. While fine print footnotes clearly says otherwise, marketing campaigns have generally led customers to extrapolate trust from their depositor status out to all banking services. To the attentive reader, the tag lines "Trust us to know." is far legally removed from "You can trust me.": and, just how many consumers of marketing campaigns are attentive readers? The typical bank deliberately seeks to build a sense of trust in the institution by claiming community status. The typical bank deliberately seeks to build a sense of trust in the bank's employees, both as members of the community (e.g., shared values) and as financially competent persons. Does this focus by the banks on the employees create a justifiable expectation by the bank's clients that there exists a trust relationship between the bank's clients and the bank's employees? Clearly, if both the employee and the customer appear to each other as mere digital streams on the internet or voices on the phone, then the bank will find it very advantageous to build a broad based sense of trust in the community. Do such marketing campaigns create a justifiable expectation of trust?

The belief in "community banks" was especially, but not exclusively, fostered by small town banks as a selling point for their institutions. Big city banks did it as well. This "community bank" trust card was even played by Hollywood as a central theme in one of its greatest movies: "*It's a Wonderful Life*". In this American classic, George Bailey (Jimmy Stewart's character), was depicted as a champion of the community and movie goers were invited to identify the "community banker" as their personal banker and a person of trust. Bailey's nemesis was a banker, but Potter was anything but a "community banker". In the movie Bailey turns down an extremely lucrative job offer whose prime reason is to stifle competition so that the community could be more completely subjugated by the banker Potter. Bailey refuses the job offer so as to protect the savings and loan (i.e., a genuine community bank) and its customers from a greedy banker. Interestingly enough, the sub-plot of the movie dealt with the American dream as expressed in real estate (i.e., home ownership in Bailey Park versus lifelong renter status in the Potter's Fields tenements). Bailey was an honest agent; while Potter serves as the epitome of the banker *qua* principal - agent problem.

Generations of Americans, many of whom do not have strong financial backgrounds, have come to trust and to rely upon the advice of their personal banker. This is not only mere respect for that individual's judgment, but is respect that has been carefully cultivated by the financial institution to garner trust with that individual's banker. To both the customer and the bank this has been sold as a "win-win" situation. As the wealth of the individual depositor increased, so to the bank grows stronger through the customer's financial strength and deposits. In effect, the bank becomes a stakeholder in the fortunes of the depositor and not an adversary. Many small businessmen and farmers have come to trust implicitly and to rely upon their personal banker's advice for all their business and personal money matters. Many times the bank's representatives, through their actions, provide comprehensive and continuous advice. Collectively, do these actions by the bank and the bank's own agents, through all sorts of facts and circumstances, ultimately create a fiduciary relationship between the bank and the client for non-depository relationships?

## **An Assumed Fiduciary**

In the last half of 2008 a crisis in banking became obvious to one and all. The current crisis revolves around banks making loans to earn processing fees without regard to whether the mortgage loans ultimately could be repaid by the customers. The originating financial institution earned its fees now, and multiple down stream processors of bundled mortgages earned fees now, and the delusion was that no one was exposed to the risk of default. A risk of default that was huge given the debtors' financial strength relative to the loan obligations. The risk was concealed under mountains of paper, each sheet triggering a fee. As Mark Twain once observed: *"It ain't what you don't know that gets you into trouble; it's what you know for sure that just ain't so."*

To assure repayment, banking had worked under a two-pronged general rule: first, the borrower had to have a depository relationship with the bank; and, the borrower had to provide proof of financial ware-with-all commensurate with prudent lending practices. The current crisis springs from the abandonment of both prongs. To expand their market and slash costs banks moved on-line and extended loans to strangers. To expand their market and boost their fee revenues banks replaced prudence with delusions of infinitely expanding real estate bubble. But, not to worry, the banks did not hold the mortgage as in days of old (when the two-pronged rule was "necessary"); the bank promptly off-loaded the mortgage into the bond market. Processing fees rather than timely payment of principle and interest became the mainstay for the bank's cash flow and profit.

Default was not the bank's risk; thus the principal - agent problem reared its ugly head in the form of moral hazard. The banks were not mere double crossing agents: the banks were triple crossing agents. The banks sold loans to clients whose financial future was sure to be disastrous; and, then the banks re-sold the same loans to equally compromised mortgage bundlers who sold to the laundered, er, bundled mortgages to investors whose financial future was just as sure to be sour.

During the mortgage boom of the last decade, many financial institutions were not exercising prudent lending practices. Additionally, and importantly for this manuscript, the banks were not being "exclusive" in providing trustful information to their customers. These institutions were violating one of the prime tenants of their fiduciary responsibility, serving two masters and profiting from both sides of a transaction. These banks provided mortgages to customers that came in the front door and then bundled and sold these mortgages to mortgage brokers at the back door, profiting from both parties. In most cases, the lender did not disclose, or get permission from the borrower to conduct the second half of this transaction. Clearly, when this scenario occurred, the financial institution was seeking to gain personal benefit from the customer's trust, relationship and subsequent transactions.

If a fiduciary relationship exists between a bank and its depositors when those depositors engage the bank for non-depository transactions (e.g., mortgage), if a fiduciary relationship exists between a bank and a non-depository client engaging the bank for a non-depository transactions, then this scenario appears to violate a fiduciary relationship. The bank's client's interests were not put first and handled with best

interest of the client in mind. Such a bank was maximizing fee revenue rather than maximizing the client's future financial stability. Remember, the banks cultivated and developed the fiduciary relationship as part of the banks' marketing strategy. By globally cultivating and developing the patina of trust, the bankers gained depositors and other clients. Further, in some cases, the lending institutions influenced their employees' decisions by way of employee evaluations. In those cases, the employee evaluations included in their employee ratings a category for the volume of bundled and sold mortgages. The higher volume an individual banker could generate in these areas the higher their remuneration. Such banks created incentives for the bank's employees to breach the client's expectation of trust. Was that expectation of trust a justifiable expectation of trust?

If the banks occupied the status of fiduciary, then breach of that fiduciary trust could generate legal liability for the banks. The bank's employees might have personal liability in addition to creating vicarious liability for the bank if the employees' own actions created a justifiable expectation of trust between that employee and a client. It can be fine line between superb salesperson and creating a justifiable expectation of trust.

If legal liability attaches, then what might be the measure of damages? The loss suffered by the beneficiary can be one measure. Another measure of damages owed can be the defendant's wrongful gain. Recall, behavior by a fiduciary that is a breach when done in the absence of full disclosure often is no where near a breach when that identical behavior is coupled with full disclosure. Is a footnote in an advertisement full disclosure? The fiduciary's full disclosure of conflicts of interest and profit must be coupled with the beneficiary's knowing and voluntary acceptance of and approval of any and all conflicts of interest. Is a footnote in an advertisement full disclosure when coupled with a paragraph buried in twenty-plus pages of closing documents?

## **Conclusions**

Financial institutions must address the above concerns. Banks are at risk of losing one of their most valuable assets: trust. Banks must ensure that their corporate strategy resonates with and reinforces the legal and ethical boundaries of fiduciary trust.

Education is a necessary, but is not a sufficient, component of the recovery plan for banks. It is a minimal requirement that banks educate the entire institution, from the board room down through the executive offices and out into the teller stands, on the bank's commitment to prevent conflicts, either legal or ethical, between the bank and its clients. There are educational programs and accreditations that have been developed for professionals in this line of work (I.E. Center for Fiduciary Studies, Accredited Investment Fiduciary Analyst, etc.). These educational programs provide training to identify potential fiduciary risks in a business. This training includes, but is not limited to, contravention of the terms in the governing agreement, self dealing (with affiliated institutions or other related parties) and questionable relationships with outside service providers. That education must be reinforced with employee evaluation criteria that create incentives for honorably discharging the bank's fiduciary duties rather than

creating incentives for employees to breach those fiduciary duties. To succeed in the long run, the bank must place the interests of its client's first.

Educating the bank's employees on fiduciary matters and creating incentives in support of those fiduciary duties is more than merely necessary: it is prudent. All bank personnel (e.g., directors, officers, and employees) need to know when their actions may be out of bounds and need to know the bank strongly prefers avoidance of such behavior. Legal problems are sure to plague those financial institutions that do not achieve these minimums. In the spirit of full disclosure (even when the letter of the law might not require it) the financial institutions ought to construct marketing campaigns that clearly inform its clients about the institution's fiduciary responsibilities and liability; but, especially to make clear when the client can not trust the bank to put the client's interests first.

Good risk management counsels each financial institution to be keenly aware of the terms of their errors and omissions insurance policies. It is the rare insurance policy that covers intentional acts. It is the rare breach of fiduciary duty that is unquestionably negligent. In a litigious universe, plaintiff seeking recovery of damages for breach of a fiduciary duty are sure to see wrongs and insurers are equally sure to see intentional wrongful acts by the insured. It is somewhat *apropos* that a suit for double dealing would be likely to generate a second suit.

Finally, each financial institution that has transformed itself from the stand alone "community bank" and become a banking system bears a particular risk because of their scope of operations. Laws vary by jurisdiction. Each nation's laws as well as the laws of each Province and each State vary materially in the area of fiduciary trust and responsibility. What is unquestionably lawful in one jurisdiction is sure to be unquestionably unlawful in another jurisdiction. Recall, truth and beauty are in the eye of the beholder. Because a corporate banking system often spans multiple geopolitical jurisdictions, and because efficiencies of size motivate the bank to have some components of the bank's operations conducted in a single jurisdiction, the bank must chose wisely which jurisdiction's laws will provide the minimum expected behavior for all bank personnel. A choice of law clause in all contracts might not be enforceable. That pursuit of efficiency might contaminate all bank transactions with the host jurisdiction's laws. To seek to be too cute by half, to seek to pick the law of the jurisdiction most favorable to the bank's intentional abuse of its clients might seriously backfire in future litigation.

Ethically, it certainly would be far superior to model the bank's operations after the laws of the most stringent jurisdiction (i.e., protects the consumer most and places the greatest duties on the bank), rather than the least stringent (i.e., allows the bank to take advantage of clients via fine print). Legally, it is almost certain to be superior to model the bank's operations after the law of the most stringent jurisdiction. Managerially, simplicity is achieved by modeling the bank's operations after the most stringent laws; while flexibility is preserved for specific transactions in less stringent jurisdictions when specific transactions that can be coupled with sufficient executive oversight and legal input.

Profit, however, might be maximized modeling either the most stringent or the least stringent jurisdiction's laws within the banking system's corporate culture. The least stringent is sure to generate greater near term profits than modeling the most stringent, if for no other reason that informational asymmetry. However, as the feedback loops bring information to consumers, the profitability of abusing trust is sure to erode. Accordingly, as Dirty Harry once asked, it all comes down to one question: "*Do you feel lucky, punk?*". When will a bank's pattern of abuse catch up with the bank's balance sheet?

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"The Foundation for Fiduciary Studies (Foundation) is a not-for-profit organization established in September of 2000 to develop and advance practice standards of care (Practices) for investment fiduciaries, which includes trustees, investment committee members, brokers, bankers, investment advisors, money managers, etc. It is independent of any ties to the investment community and therefore positioned to be a crucible for advancing the Practices throughout the industry."
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