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OFFSHORE PILOT QUARTERLY

Commentary on Matters Offshore

June, 2004. ***Volume 7***
Number 2

Advice from a Pope

Much has been written about conflicts of interest in business. The danger of compromise is ever-present, particularly so in the case of offshore financial services. Let's take a simple example and one which I have encountered since I first went offshore in the 1970s. An offshore bank, say, has a subsidiary trust company which manages millions of US dollars on behalf of beneficiaries of trusts and foundations. The financial welfare of the bank and its trust company are (which is often the case) inextricably linked and, quite naturally, any customers of the bank requiring the services of a trust company are going to be pointed in the direction of its subsidiary; conversely, when the trust company needs banking facilities for its clients it will look to its parent bank to provide them. The arrangement works fine for the bank, but not necessarily for the trust company which must not, despite its affiliation, put the bank's profits before its fiduciary responsibilities. If the bank account the trustee is opening is just a current account, earning no interest, then one bank is as good as the next (assuming all are financially sound) but it can get complicated if things move beyond that point. If large amounts of cash are kept by fiduciaries (a generic term for both trustees and foundation councils) with a parent bank on current account when they shouldn't be, a line has been crossed. The parent bank's treasury department will welcome this ready supply of cash and although this profitable (for the bank) and prejudicial (for the beneficiaries) arrangement is bad enough, it can lead to worse things. I am reminded of Benjamin Disraeli's comment that "a precedent embalms a principle". The lure of the pecuniary honey pot can mean that accounts with a parent bank become the slippery slope down which the flawed fiduciary in my illustration slides. Not only are bank accounts opened, but the bank's other investment products (such as mutual funds) are likely to be invested in (unless the fiduciary's investment guidelines stipulate otherwise) even although better returns might be available elsewhere.

Corporate fiduciaries in danger of being compromised in this way need to be fire-walled, perhaps by creating an investment committee that must ensure that managed assets are only placed with a parent bank when it truly offers the best opportunities. I am not advocating a ban on the use of in-house products by fiduciaries, but I am saying that fiduciaries have one simple question to ask themselves ahead of doing so: will the beneficiaries of the assets or my employer benefit the most? It is unquestionably very hard for a corporate fiduciary put in that position because so often the bank and trust company have the same directors who find themselves wearing two hats: financiers and fiduciaries. But the distinction is a crucial one, especially when things go wrong. What if the parent bank was struggling with liquidity and eventually went under? Would beneficiaries want to ask the trust company whose best interests prevailed when deposits (perhaps large sums placed in current accounts) were made? What a wonderful entrée for any lawyers hired by beneficiaries. Certainly, in the heady days of offshore financial services in the

1960s and the 1970s such conflicts of interest were quite common whereas today there are more qualified and experienced offshore trust managers. The banker/fiduciary distinction – and therefore the responsibilities – might be more readily understood today, but the potential for conflicts remains, especially when trust managers are salaried employees of a parent bank and not independent practitioners. Choosing an independent trust company will make the banker/fiduciary conflict described academic, but, as you will see, you have only removed one potential avenue of conflict.

Foundations have been likened to companies and when asked for a one-sentence explanation of the difference between them, I have replied that they are both companies except that one has shareholders and the other beneficiaries. The duty of either a board of directors to shareholders or a foundation council to beneficiaries, however, remains the same: they are fiduciaries of other people's assets. The same, of course, applies to trustees. In the March issue of the Offshore Pilot Quarterly mention was made of the fundamental mistake that directors of companies (such as Enron) can make when they forget the fiduciary duty they owe to shareholders. The picture is clear for directors (although, apparently, not for some at Enron) because there is a straight line of responsibility but less so for foundation councils or trustees where complex estate planning can mean that beneficiaries have varying rights and interests which must be balanced by the fiduciary. The complexities can be manifold and a fiduciary must, of necessity, have appropriate formal training as well as experience in administration, accounting and law. Nothing less will do. Often, for example, a client may create a trust or foundation for his minor children, gifting assets outright and placing them in the hands of a fiduciary. Quite naturally, although the assets are no longer his, the interests of his children are paramount in his mind; but unless he has retained some legitimate control over how those assets are to be managed, it will be up to the fiduciary (who must understand his position) and not to the father to place the investments (although the fiduciary should take into consideration the father's views). If a fiduciary forgets the difference between his client's interests and those of the beneficiaries he could get into deep water. The fiduciary, by the nature of his function, has to deal with immediate as well as distant events and the gestation period from when the seed of a breach of trust is created and the time when it develops fully into a claim can span many years. Succumbing to the bullying of a client (who may have separate and substantial business with the fiduciary and which the latter would be loathe to lose) has resulted in dire consequences when the fiduciary was subsequently brought to account by beneficiaries after they became adults.

Enron directors also compromised their duties by the relationships which they developed with some of their advisers and consultants. It was dollars, not duty, that held sway and reward, rather than reputation, that mattered. Those advisers and consultants, for their part, were more concerned with keeping the business than their independence. Trust companies, of course, use advisers and consultants too, who are usually happy to offer commission for business introduced. Even if the trust company's mandate permits it to receive commission, it still doesn't mean that the fiduciary should not first consider the levels of competence and competitiveness, rather than the commission, being offered. The solution for fiduciaries might be unpopular in some quarters but it is a simple one: do not accept commissions or other inducements at all. Corporate fiduciaries, under normal circumstances, should not even accept sponsorship of either published materials, such as newsletters, or their websites from professionals in allied businesses.

Professional fiduciaries have to confront a minefield of conflicts of interest, whether they are employed by banking groups or not, making it imperative that they heed the advice given by Alexander Pope that "a little learning is a dangerous thing, drink deep, or taste not the Pierian Spring". They require the necessary skill and integrity before they don the mantle of a

professional fiduciary; by drinking deep they will probably avoid getting into deep water.

Salmon, Crowns and Lace

How often do you decide to try meat at a restaurant which specialises in fish? My experience has inevitably been that even if the steak that you ordered is passable, the salmon you had last time was infinitely better. That's because the restaurant specialises in fish. Such thoughts occurred to me recently during a conversation with my friend, Ben, over coffee. He had become dissatisfied with a trust company which had managed some of his affairs for several years but which had now diversified into new areas of business. I suggested that they were spreading themselves too thin by straying too far from their primary services. They were not, in colloquial terms, sticking to their knitting, much in the same way as two former corporate giants (see below) had not and I told Ben that in the fiduciary's lexicon under c, along with compromise and competence, the word concentration should be included.

I reminded Ben that Enron, to add to its multitude of sins, some of which have already been mentioned, was also guilty of not concentrating on its central business. It was a regulated utility that decided to revolutionise the energy industry, losing its prime focus and expanding into fields such as healthcare transport. Inchcape, on the other hand, came from a different culture but this had no bearing on the end result. It had started life in the 19th century in India and its founder, James Lyle Mackay (the first Lord Inchcape), turned his company into one of India's largest before returning to England in 1893. By then Inchcape, although its background had much more in common with tea estates and the opium trade, had been turned into a huge commercial empire. Importantly, however, Mackay had never gone into a business he didn't understand. When offered the throne of Albania in 1921, for instance, he refused because "it is not in my line". He died in 1932 and I wonder what he would have thought about Inchcape's subsequent involvement in insurance broking, Coca-Cola bottling in Chile and shipping in Singapore? In fact, when the company reviewed its spread of businesses in the 1980s (Trust Services, S.A. was once owned by it) it had interests in more than 500 companies in 44 countries. But it had lost its way and, as a consequence of this, became a shadow of its former greatness. It can be so very different.

Austria, famous in offshore circles for its banking secrecy, is also renowned for its mid-sized companies that have concentrated on a few products, stayed close to their customers and paid attention to quality. The tramway company Doppelmayr and the Sattler textile group (more about looms later) are cases in point. In an earlier, less complex, world, generalists prevailed. Adam Smith is an example: he was a classical scholar, moral philosopher and lectured on jurisprudence besides being a founding father of the discipline of economics. He was even an expert on the subject of natural science (his essay on the history of astronomy remains an invaluable contribution to the methodology of science). In today's world, however, such individual diversity would be considered impossible. Specialisation has become necessary and, at the end of the Victorian era, Emile Durkheim, the French founder of sociology, was so adamant about the subject that he saw a refusal to specialise in areas of business as detrimental to the social prosperity of us all. Adam Smith propounded a division of labour (emulated by Henry Ford) which led to his classic example of the pin factory following a visit to one. Smith argued that a man working by himself and starting from scratch might possibly have made only one pin a day whereas by the development of individual, distinct skills, the factory's daily output was far greater because of the collective efforts of a team.

Companies today gain competitive advantage through their own distinctive capabilities and I said to Ben that in my view when you are looking for trustees, for example, you should think of old-fashioned lace; he gave me an old-fashioned look and then I explained further. There are 1200 Leavers lace looms (named after the 19th century English inventor, John Leavers)

left in the world. The looms are both slow and labour intensive and none have been built since the beginning of the 20th century because the cost would be prohibitive. So how do these antiquated pieces of machinery stand their ground against today's technical wizardry? By simply making the finest lace through slow, but exacting and specialised, procedures.

I mentioned to Ben also that governments, as well as commerce, can suffer from lack of focus. This led us on to another subject: the current status of the Organisation for Economic Co-operation and Development's tax harmonisation programme. It is a subject which had come up on a previous occasion when Ben and I had met for coffee (see the OPQ, Volume 5, Number 4). The European Policy Forum (a London think tank) has been highly critical of the OECD's tax tactics. Put better than I could, the EPF says that the desire to facilitate the interests of tax collection and reduce competition seems to have been the OECD's driving force. Coupled with a wish to remove tax policy options for independent jurisdictions has been a failure by the OECD's Fiscal Affairs Committee to consult experts in economics and law; reliance on its own inadequate judgement has been counter-productive. Thoughts of Alexander Pope spring (in more ways than one) to mind.

Walter Bagehot, the wry 19th century journalist, banker and critic reminds us that even a skilled bureaucracy is, nonetheless, inconsistent with the true principles of the art of business. This suggests that the road to international tax harmonisation, and still under construction, will be a very long one indeed. Finding a solution to Ben's trust company problem will be much easier. He just has to find the right restaurant.

Offshore Pilot Quarterly is published by Trust Services, S. A. which is a British- managed trust company licensed under the banking laws of Panama. It is written by our Managing Director who is a former member of the Latin America and Caribbean Banking Commission as well as a former offshore banking and insurance regulator. He has over 35 years private and public sector experience in the financial services industry. Our website provides a broad range of related essays.

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