Trailer Fees: The Untapped Revenue

By Pascal Crépin and Martin Straub
Envisage Wealth Management
Zurich

The recent decision by the Swiss Federal Court regarding trailer and distribution fees has shocked many (Bundesgerichtsentscheid zu Retrozessionen). It shouldn't. It is broadly in line with the intent of regulators in other countries: Trailer fees on products used in discretionary mandates belong to the client. If the bank has received these trailer fees it may be required to repay them to the client. The big difference with this decision was that the obligation is not only limited to third-party funds but extends to the bank's own funds and structured products. The ruling should be seen as an opportunity to review banks' trailer-fee management overall, for products used in both discretionary mandates and execution-only accounts.

Many banks are currently not in a position to capture the entire range of positions that they hold. They are also often not in a position to capture the entire revenue that is due to them. Before banks can even think about reimbursing any fees to their clients, they need to gain the necessary transparency on the positions they hold and the fees they are entitled to receive in the first place.

Most traditional equity, bond and strategy funds pay trailer fees to compensate the banks and other distributors for their marketing and sales efforts. These trailer fees represent a substantial source of revenue to the distributors and are compensation for service provided.

However, distributors are often not in a position to realize the full revenues on those products that do offer trailer fees. Substantial product positions fall through the net and rates agreed are often below market benchmarks.

The rewards to trailer-fee optimization are substantial and recurring.

Coverage ratio

In many cases, banks face difficulties in properly identifying all the positions they hold and billing the expected revenue. Sometimes, assets are spread across a bank's booking centers with different custodians. Proper reconciliation is not done due to cross-regional and cross-divisional complexities of the organization. As fund providers use different methodologies to calculate fees, banks lacking proper systems to replicate the different calculation methods may not be able to calculate the fees that are due to them.

Reconciliation of payments received against what is due according to the agreement does not take place regularly, systematically and thoroughly. In these cases banks tend to forego substantial fee income – it simply never gets collected.

Sub-market rates

Trailer fees as compensation for the distribution effort are set individually and there is seldom a set rule by market, by share class or by country. Some banks with small volumes may actually receive higher trailer-fee rates than their much larger competitors with much higher volumes. This may be due to a less stringent approach to generating revenues or simply to varying negotiation skills. These organizational realities mean that some banks can be losing up to half of the trailer-fee revenue due to them.

What can be done?

We have identified three levers that banks can work on to optimize their trailer-fee income:

Increase coverage: Bundling volumes across the organization's divisions and booking centers can substantially increase coverage of products that pay trailer fees. By scanning their positions regularly, distributors can identify positions that do not pay trailer fees and approach product providers to negotiate distribution agreements.

Get better trailer-fee rates – improve the deal: With higher volumes, product providers tend to offer better rates. Independently benchmarking rates received will help optimize trailer-fee revenues, because this gives insight into current best practice.

Use outsourcing opportunities: A number of third-party providers allow distributors of fund products to outsource the value chain either in part or entirely, from contract negotiation to order routing to trailer-fee management. This can lead to higher revenues through higher trailer-fee rates, lower transaction and custody costs and help circumvent restrictions on minimum thresholds, with full transparency and computation of trailer fees.

Successful implementation of trailer-fee optimization requires a coordinated bankwide approach where product management, legal and financial controlling work as a team, often with an outsourcing provider. However, outsourcing these non-core activities will only lead to increased revenues, if the provider with the right fit is selected. Providers offer great variety in business models, cost and fee structures, custody arrangements, coverage of products and, most importantly, highly divergent rates. Once all steps have been taken to ensure stringent and meticulous trailer management, banks will be in a position to know their positions, the revenue that they should be generating vs. the revenue that is booked, and which portion of this revenue can be repaid to the individual client, if and when required.

pascal.crepin@envisage.ch
martin.straub@envisage.ch
www.envisage.ch