The Diligent Bank Gets Its Due

By

Michael D. White is Managing Director of Financial Institutions Insurance Association and President of Michael White Associates, Bank Insurance Consultants, Radnor, PA. MWA@BankInsurance.Com

Due diligence is a critical responsibility of those preparing to sell insurance products, be they agency managers, insurance brokers, traditional career agents, or bank-based agents.

Most of us are aware of the importance of protecting customers from the dangers of an unsound product and a financially unstable insurer. Although agents, executives, and managers are sometimes overwhelmed at the prospect of undertaking insurance company due diligence efforts, there are plenty of publications, internal bank resources, and external consulting services to help carry out the essential task of selecting safe and appropriate products and carriers.

While the job of choosing solid insurance companies and products is important, it is not the sum total of a due diligence project. Due diligence for bank insurance programs involves more than evaluating the financial solvency and stability of insurance underwriting companies. Thorough due diligence focuses on more than insurers' balance sheets, investment portfolios, asset/liability management, and product offerings.

Due diligence entails looking at all aspects of a proposed bank insurance program; evaluating each vendor's assumptions, projections, operations, and performance; and recommending to the bank the best choice.

A due diligence report sets forth the findings and conclusions reached regarding the relative merits of competitors. It advises the bank of their respective strengths and weaknesses and recommends the best way to proceed in order to protect the interests of the bank, derive the greatest economic benefit for the bank, and provide the best products and services to the bank's customers.

Legal and regulatory requirements sometimes mandate that a third-party vendor market and sell insurance products in a bank environment. Because it must rely on unaffiliated vendors (such as insurance companies, independent agents, wholesalers, limited retailers, turn-key retailers, direct marketers, management companies, and administrative systems suppliers), a bank must proceed carefully to protect its interests, its customers, and its customer relationships. The professionalism and performance of the vendor is as critical to the success of a bank insurance program as is the bank's support of the vendor's efforts.

Recurring trailer commissions build substantial value for a bank that seeks to develop a long-term insurance program.

The objective of an insurance program — and the due diligence report that guides it — is to maximize the economic benefits to customers and the bank without disturbing the delicate relationship between the two.

Hard-Dollar Costs

A first step in undertaking vendor due diligence is to calculate the bank's cost to start and maintain an insurance program. Ask each vendor to provide an explanation of items for which the bank must pay and their estimated costs. Will the vendor pay for literature, sales promotions, field personnel, administrative forms, physical facilities, and equipment?

I recall one due diligence effort in which the vendor did not provide a hard-dollar cost estimate of those items it required the bank to "provide, own and maintain" in each branch office. Among those items required were adequate office

space, office furniture, a file cabinet, a telephone unit (including installation, monthly service and long-distance charges), and general office supplies.

Cost estimates obtained from the bank's purchasing department and phone companies showed that the bank's hard-dollar costs would exceed $530,000 over five years. This reduced, in the same amount, the aggregate fees and net pretax income paid to the bank as shown on the vendor's pro forma and represented a 7 percent reduction in first-year fee income.

Soft-Dollar Costs

In addition, don't forget soft-dollar costs. These are costs incidental to personnel and facilities that do not require the bank to actually make a cash outlay. An insurance program proposed by a vendor will almost always have soft-dollar costs. It is not easy for a bank to track them, but they must be calculated.

Depending on the permissible activities of bank employees relative to the insurance program, a financial institution may incur soft-dollar costs when an employee answers the agent's phone in the branch and takes messages or calls the vendor's service center to schedule an appointment for a bank customer with an agent; when an agent uses a desk, office or small conference room in the branch to meet with a customer or uses a bank photocopier; or when a bank must allocate branch space for vendor-agent offices.

These examples begin to reveal some of the soft-dollar costs that a bank may incur in order to have an insurance marketing and sales program. These costs do not negate the benefit of such a program, but they should be considered when evaluating vendors' competing proposals because soft-dollar costs may be substantial.

Trailer Fees

When examining the fee/income pro formas of vendors, subtract any previously hidden or unmentioned hard-dollar costs in order to determine the net pretax income that the bank expects to earn. Be responsive to innovative proposals that offer creative forms of less common or less traditional fee-income payments.

For instance, some single-premium or initial lump-sum premium products are designed to pay trailer commissions, not just one-time up-front commissions on new money. Recurring trailer commissions usually mean reduced up-front commissions, but they build substantial value for a bank that seeks to develop a long-term insurance program. These residual commissions essentially create an annuity for the bank. Over the long run, they are usually far more enriching to the bank than quick, one-time, up-front commissions.

These trailer products and commission/fee structures are increasingly important when linked to the contractual features of a buy-out agreement. Under a buy-out agreement, a bank may exercise an option to terminate its relationship with a vendor-agent and purchase the agency and the future trailer commissions that may attach to the block of existing business.

If a vendor proposes to pay your bank trailer commissions or fee income, calculate the net present value (NPV) of the trailers on an after-tax basis for the business written in each year of the pro forma.

As with any projections, the assumptions used to do the NPV calculation will impact the final result. These assumptions include product mix, average sales date, policy lapse rates, annuitization rates, mortality experience, return on assets, discount rate, date of vendor termination, length of trailer commission payout period, and annual timing of trailer commission payment. If this task seems too complex, hire an independent actuarial or consulting firm to calculate the NPV. It could be well worth your time and their fee to use outside help.

The total after-tax value to a bank of a vendor's program is the sum of the cumulative after-tax net income and the after-tax net present value of any future trailer fees. One trailer-fee case I worked on showed an additional first-year NPV of a half million dollars; added to the first-year after-tax net income, the proposed program with trailer fees exceeded the cumulative after-tax value of the nearest competitor by more than 80 percent. At the end of five years, the cumulative after-tax NPV of trailer fees was $3.75 million.

Two Objectives

Conducting proper and thorough due diligence means a bank has two major objectives when it evaluates and considers proposed insurance programs (including a bank-owned, bank-run agency distribution system). These two objectives are "diligence" and "due."

"Diligence" is the watchword as a bank makes its choice of an insurance partner and the contractual relationships into which it will enter with this partner. A bank insurance venture must be sound for all concerned, but first and foremost it

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must be prudentially sound for the bank, the bank's customers, and their mutual business relationships. The products must be good, the insurer must be financially strong, and the third-party operations must provide excellent service to bank clients and not harm bank-customer relationships.

In addition, a bank seeks its "due" when it examines vendor proposals. A contemplated partnership with a vendor should be economically sound. Financial projections must be realistic and attainable, and each party should disclose or discover all related costs, both hard-dollar and soft-dollar. A bank's relationships with insurers and vendors must ultimately produce a suitable return for the bank. They should make economic sense and enable the bank to earn its "due."

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