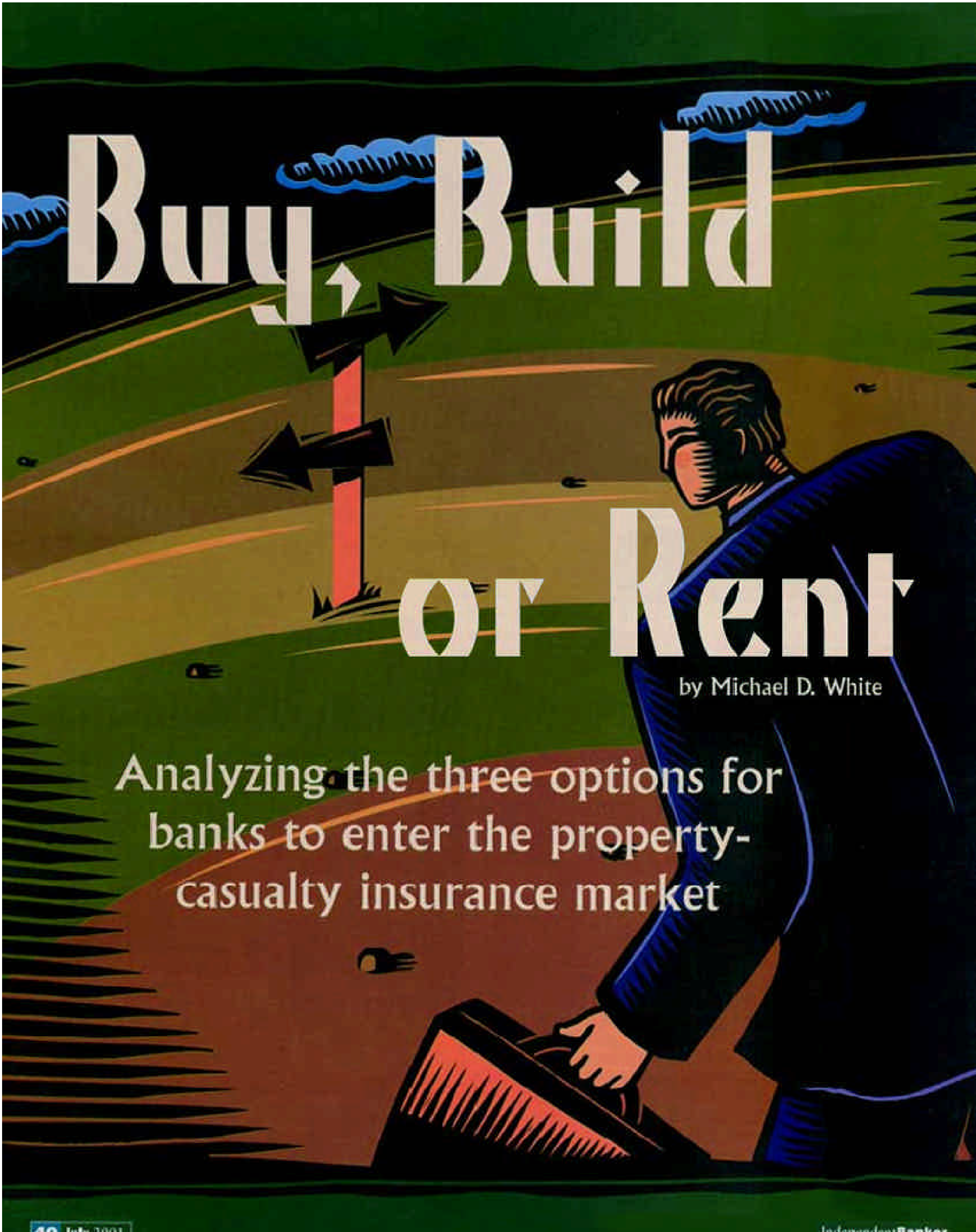

Buy, Build or Rent

by Michael D. White

Analyzing the three options for banks to enter the property-casualty insurance market

There are three ways banks may enter the property-casualty insurance business: buy, build or rent. In the buy scenario, a bank acquires an existing insurance agency. In the build mode, a bank creates from scratch a brand new (de novo) agency. The rent approach entails a bank negotiating an outsourcing agreement with an unaffiliated agency or marketer to provide insurance products and services on the bank's behalf to its customers.

Some commentators explain these insurance market-entry methods simplistically by outlining lists of pros and cons. But comparing and contrasting these methods is not as simple as that. For instance, one of the typical cons offered against buying an agency is that it requires significant capital outlay.

Obviously, significant capital outlay is necessary for an acquisition. But, for a bank with an ROE of 9 percent and total risk-based capital ratio of 18 percent, such an outlay is not a drawback. This bank's capital is underutilized and less productive than it should be. It ought to be re-deployed to improve the bank's low ROE.

A capital outlay then in a new investment like an insurance agency is not an argument against making an acquisition. Indeed, assuming the acquisition is a valid strategy for this bank, it could be seen as a necessity. Does an acquisition carry a risk? Surely, as does any employment of capital, including its underemployment. (Recall the proverbial pile of money stuffed by its owner in a mattress?)

So, let's modulate our discussion of the buy, build or rent methods of market entry by talking about their potential benefits and issues to consider. The benefits are potential, depending upon the facts of each bank and agency's particular situations. Likewise, the concerns or issues to consider in making a market-entry decision are dependent on their specific contexts and circumstances.

Universal Issues

Each bank must consider and address certain issues that are universal to any contemplated form of insurance-market entry – whether it builds its own agency, acquires an agency or outsources its insurance activities. Some issues are common to the process of market-entry decision-making. Others arise during implementation and launch of a bank insurance program. Important questions bankers ask in virtually all circumstances include:

- How much capital is required?
- What is the quality of the insurance provider and its underwriting contracts?
- How much insurance fee income will flow to the income statement, and when?
- Who controls and manages the processes and outcomes?
- What are the products to be offered and plans for distribution and commission sharing?
- Who owns the customer?

Regardless of the method, a bank's entry into insurance often leads to discussion about a potential clash between the sales and nonsales cultures of insurance sellers and bank employees. Insurance requires a sales culture, and the bank may not be able to incorporate this adjustment readily or easily. It takes time to acculturate bank employees and transform the bank's operating environment to accommodate the insurance sales culture. Culture conflict is best resolved by reconciling differing management styles and philosophies of the agency and bank management teams.

Agency management succession preparedness is also a universal issue. Additionally, a bank must be concerned about customizing marketing and sales plans, maintaining flexibility in its distribution strategies and achieving high levels of productivity in distribution. These concerns are common to the subject of a bank entering the insurance business. Others are more specific to the precise method of market entry.

Buying an Agency

The key potential benefit of buying a property-casualty insurance agency is immediate entry into the insurance market. If it buys a large, prestigious agency, a bank virtually inherits the recognition and status of a leader in its local market. Assuming there are no change-of-control provisions in the insurers' contracts with the agency, the bank attains immediate access to the agency's insurance carriers and products.

In leveraging its capital through acquisition, the bank gains day-one revenue. It uses its financial capital to purchase human capital, thereby filling its void of insurance expertise. The bank gets experienced agency management … that, under a buy-out contract, stays after the acquisition.

A good agency brings product, marketing, sales and service skills; intact agency systems; and operational structures and protocols. Depending on the agency's diversification of business, its producer infrastructure may broaden the bank's insurance strategies and market or customer initiatives, enabling the bank to offer personal lines, commercial insurance and group life and health insurance.

Moreover, bank ownership of the agency gives it control over insurance management, marketing and sales, customer-service relationships and ultimate ownership of the insurance accounts of bank customers. An agency acquisition also eliminates termination issues as encountered with third-party agencies that perform sales for the bank under outsource-agreements. The bank not only acquires the agency's revenues and profits currently produced in the open market, but it also should subsequently leverage the agency's value to a higher level when it begins generating insurance sales among the bank's customer bases.

Reciprocally, there are potential reverse-flow opportunities; that is, the agency can cross-refer insurance customers who have banking needs. Finally, an acquired agency can serve as a platform for launching future acquisitions of insurance agencies or blocks of business.

Buying Issues to Consider

Banks must carefully consider a number of issues when contemplating buying an agency. These are not necessarily negatives or arguments against buying agencies, but they do strike cautionary notes as banks evaluate this course of action.

As noted, a substantial capital outlay is required to purchase an agency and for the working capital to operate and expand it. And, acquisition increases fixed expenses in the bank's consolidated income statement. Targets set by the bank's board of directors for returns on investment, assets and equity may dictate that a purchase is not feasible.

Evaluating an agency's strategic, tactical and cultural fit, valuing its fair market value and negotiating the purchase takes considerable time away from banking activities that need attention. Before buying, the bank must make certain there are no contractual change-of-control repercussions that would harm the agency if bought. Bank and agency management must avoid inflated or unrealistic value-expectations, before and after the acquisition, which harm the budding insurance program.

The bank must determine whether the agency's technology is inadequate or not adaptable and needs upgrading or replacing. Also, the bank's customer service orientation has not previously been subjected to the property-casualty claims process. Any backlash from disputes over claims may be new and unnerving to bank management. Attention must be paid to post-acquisition retention of the agency's existing customers at the time the bank purchases it.

Finally, the agency's principal must be motivated to continue to expand and flourish the agency after the sale as before it. This requires performance-bonus mechanisms that ensure the principal's commitment and resolve to attain the bank's insurance goals.

Benefits of Building

The ostensible benefits of a bank building its own property- casualty insurance agency are not as numerous or compelling as those of buying or renting a property-casualty agency. (This is not true in the case of a life insurance agency, which is much easier to build than a property-casualty agency.)

In building a new property-casualty agency, a bank certainly has complete control over management, operations and the customer service relationship, and one assumes that ownership generally enhances commitment. A *de novo* agency necessitates organic growth through the sale of sufficient volumes of premium to bank customers. Sales distribution is a blank slate, and the bank may be more able to customize its distribution systems to its own specifications. However, the financial pressures of a *de novo* operation's high-cost entry argue against this incremental approach to the insurance business.

Building Issues to Consider

Building a property-casualty agency is riskier and more expensive than buying or renting an agency. It requires significant investment in time by the bank's senior management team, as well as a substantial capital outlay before any revenue generation. The market-entry cost is higher with all the start-up expenses; and, for several years, fixed expenses will be higher than those of a mature agency.

Decisions must be made about business technologies as well, and the physical location of a new agency requires suitable facilities at the bank, which add further to the start-up cost. The bank can expect a de novo property-casualty agency to run in the red for a long time.

When a bank decides to build, it has no carrier contracts, customers or track record and, therefore, runs the serious risk of not getting top-quality carrier contracts or, possibly, any contracts at all. If it gets contracts, their commission terms will likely be weaker than those of established agencies.

The lack of critical insurance experience within the bank places more demands and pressures on the incipient operation. With no sales force and no sales management, the bank must recruit all personnel from scratch – a process consuming time and money, adding further to lost-opportunity costs. Poor judgment in recruiting sales and service staff will retard development of employee quality and productivity. And, the additional costs of training a new staff and management must also be considered. These potential problems in building a new property-casualty agency from scratch indicate that bank management will be learning about the insurance business the hard way – mostly on its own.

Benefits of Renting

The rent method of entering the market is, perhaps, least risky, requiring lower initial and ongoing capital outlays than buying an agency or building one from scratch. The bank and an agency enter into an agreement whereby the latter provides the insurance expertise and manpower for selling insurance on the bank's behalf to its customers.

Here "rent" does not mean the agency rents space from the bank. The agency's expertise and skills are the objects of the word rent, not space in the bank lobby. The bank is outsourcing the insurance sales and service functions to a competent, but unaffiliated third party. In return, the bank receives almost-immediate fee income from a sales program that is installed fairly quickly.

Revenue is generated quickly because the bank and its duly authorized agency gain immediate access to insurance company contracts and products through its marketing agreement with the agency. In renting the agency, the bank also takes on its carrier relationships and scale of production to maximize insurance contracts and commissions.

Of course, the bank gets more than experienced management and a tested sales force. It benefits from the agency's existing technologies and established operating routines and protocols. The bank's training costs are generally reduced, because the agency has knowledgeable, insurance-trained staff who can train bank personnel. The marketing and sales agreement is generally adaptable to changing needs and circumstances. Lastly, the bank gets an education from, and with, the resources the partnering agency offers. The bank is thereby enabled to test its opportunities for selling insurance to its customers with typically less risk than buying or building.

Each bank must consider and address certain issues that are universal to any contemplated form of insurance-market entry—whether it builds its own agency, acquires an agency or outsources its insurance activities.

Renting Issues to Consider

While renting or outsourcing reduces certain risks, it does not eliminate all risks or issues confronting a bank. A major risk to renting market entry is, in fact, the bank's strategic reliance on a partner. Since bank insurance is a new and evolving distribution arena, it is rare to find a partner with a recognized bank-marketing track record. The agency selected must be of high caliber and demonstrate a major commitment to make the bank insurance program work. Of understandable concern is the outsourcing agreement's status in the event of any change of control at the agency.

Because the bank is using an unaffiliated agency to distribute insurance, it has no direct control over distribution costs. Were the bank to own its distribution, it would likely seek to change certain costs. But, by renting distribution from an agency, it usually has to settle for the current compensation structures of the traditional agency system. It is also difficult for agencies and carriers to segregate bank sales within the aggregated books of business that produce contingency commissions. So, while the independent agency may receive contingent commissions on business written with bank customers, the bank will reap none of that benefit.

Another issue that must be carefully addressed is the potential for confusion on the part of bank customers. A proper compliance program and appropriate promotions, advertising and signage will help abate confusion, but it remains a concern because the partner is not affiliated with the bank. Lack of affiliation can also inhibit support of bank employees, producing less commitment than desired. Thus, it is important that bank and agency management work closely and, together, communicate to bank employees the nature of the program and why it is important to customers, shareholders and bank employees alike.

An important threat to this arrangement can be customer "raiding" or "selling away." Therefore, proper systems must be installed to track all referrals and the results of sales interviews to prevent the raiding of bank customers and placement of products outside the agency and bank's agreement.

Finally, both the bank and its partnering agency must be realistic and honest in all their interactions, especially in their business planning and reporting. Inflated and unrealistic expectations can produce as much damage to a bank insurance program as anything. When expectations are too high and results fail to reach them, disappointment and discouragement can sink very low. Moderation, perspective and constant, open communication by both partners are the best antidotes to false expectations.

Licensed Agencies

If a banking organization does not already have a licensed agency, it should when entering into a rent or outsourcing agreement with a third-party agency. The agency may be a "shell" agency, that is, only operable to the extent it is licensed. While outsourcing to obtain skills and services, the bank's agency receives and processes the bank's share of commissions earned from the production of the unaffiliated agency.

A bank should form a shell agency for several reasons. First, an appropriately licensed agency serves as a legal vehicle by which the bank can receive a significant, meaningful share of commissions. Without an agency that serves as a legitimate receptacle for the bank's share of commissions, some insurance regulators might challenge the amount of the bank's compensation, its percentage-calculation, or the services rendered to justify such compensation.

When a bank has its own licensed agency that enters into an outsourcing agreement with an unaffiliated agency, it is contracting with that agency for services for which, in essence, it is rendering payment. On the other hand, without a licensed agency, insurance regulators may call into question the bank's compensation, which now can only be viewed as the result of the bank offering services to the unaffiliated agency, not vice versa.

Some states, for instance, do not permit space-rental or lobby-lease agreements between a bank and an unaffiliated agency. Most states prohibit percentage-lease agreements and treat such compensation as illegal receipt of commissions by an unlicensed entity.

Rental of customer lists used to be a common way for banks to circumvent anti-affiliation prohibitions against their selling insurance directly; third-party vendors would pay to "rent" banks' customer lists. Increased attention to protecting customers' confidential, private information, however, is sending rented customer lists the way of the dodo bird. Thus, it is simpler and cleaner from a regulatory point of view for banks to obtain agency licenses to receive shared compensation for other's insurance sales to their banking customers.

A second reason for having an agency, whether it is active in some lines or just a shell, is that the bank may provide more meaningful monetary incentives to bank employees for making customer referrals to the insurance program. Most states appear to agree with banking regulators' position that bank employees may be paid an incentive fee for making a customer referral, as long as the amount is nominal and its payment is not contingent on the consummation of a sale.

But, for instance, if a bank wanted to compensate commercial lenders $500 for each referral that results in two commercial insurance sales, it would be able to do so as long as it has a licensed agency and requires its commercial lenders to obtain property-casualty licenses. Again, ownership of just a shell agency, gives the bank's insurance program and support systems greater strategic and tactical flexibility – all within the boundaries of bank insurance law and regulation.

Thirdly, when a bank owns an agency while outsourcing insurance-related functions, it is then positioned to negotiate an actual ownership interest in the insurance book of business created by third-party sales to banking customers. If, however, it has no licensed agency, the bank has no legal basis to claim or negotiate an ownership interest in those insurance accounts.

The fourth reason is closely related to the third. Owning an agency means a bank may negotiate a marketing agreement with an unaffiliated agency that stipulates the bank's percentage ownership share in the business being written. The marketing agreement may also contain provisions permitting the bank, upon termination of the agreement, to internalize the insurance program by acquiring the third party's ownership interest in the bank insurance program.

Meaningful commission-shares, more-than-nominal referrals, partial ownership in the business being built, and the capability to acquire the entire book of business necessitate a bank's ownership of an insurance agency, shell or otherwise.

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A version of this article first appeared in
Independent Banker *,*
July 2001, V.51 N.7, pp. 40-47
*"**Buy, Build or Rent**"*
BankInsurance.Com — Internet Version