On My Mind

Making Money with Bank Insurance

By

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Despite recent record profits, it is universally acknowledged that the traditional banking functions that produce transaction fees and interest income from declining net interest margins will not preserve commercial banking. The banking industry's net interest earnings will continue to decline as a percent of contribution to total bank earnings and never again be sufficient alone to sustain the business of banking. That the average net interest margin has reached new lows since the early 1990s is indicative of this truth.

Banks need noninterest fee income

To survive and thrive in an environment populated by nonbank competitors, more is needed than expense reduction, consolidation, mergers and expansion of banking's traditional businesses. While the entire banking industry increased noninterest income as a proportion of bank income from about 17 percent in 1960 to 42.3 percent in 1998, community banks lagged significantly in this department. They must do more to grow their fee-based income.

From 1986-97, noninterest income grew at a compound annual rate of slightly more than 10 percent, exceeding the 3.3 percent growth in interest income during the same period. Over the past two decades, the share of credit provided by banks and thrifts has dropped from a high of more than 66 percent to a low of 44 percent. Consequently, domestic assets of commercial banks and thrifts experienced the slowest rate of growth during the period 1986-96, averaging a 2.8 percent annual rate. Meantime, assets of finance companies grew at 7.9 percent, pensions and insurance companies at 9.3 percent, and mutual funds at 18.6 percent.

More than other fee-income products, insurance sales offer most banks the greatest potential for increased revenue and profits.

Financial institutions no longer hold a dominant position in loan origination, intermediation, servicing and distribution. They now compete with specialized providers in each of these now unbundled functions. As former Comptroller of the Currency Gene Ludwig warned, "The core of banking's traditional lending business is fast disappearing…. A dwindling core business, increased competition, changing consumer needs, and – most significantly – a dynamic environment in terms of technological change and globalization means that banking cannot stand still."

To accelerate properly sufficient growth in noninterest income, banks need to enter new markets in which they can build new customer relationships and, thus, develop new sources of revenue. Additional financial services, not previously the purview of the banking sector, must be provided to consumers in an efficient, effective, economical and profitable fashion.

Fee-income activities like insurance sales can add initially 2 to 4 percent to a bank's bottom line – and as much as 5 to 10 percent within 5 years, reducing a bank's impetus to take bigger credit risks to achieve needed profits.

Bank annuity/investment product sales

Insurance sales offer most banks the greatest potential for increased revenue and profits. Thus far, insurance has contributed little to banks' fee income, but that is understandable. We are only at the incipient stages of insurance activity in the banking community, having waited for the dust to settle in the wake of the *Barnett* decision and the passage of new

bank insurance laws in some two dozen states.

Bank insurance is now at the stage the bank annuity market was a decade ago. In 1987, consumers purchased about $4 billion in annuities from their banks. In 1997, bank annuity sales tallied $20.2 billion constituting gross commissions in excess of $1 billion, a five-fold increase in ten years. (Final 1998 results are yet to be tallied, but are estimated to be near the record 1997 total.) From 1990-98, financial institutions sold $130 billion in annuity premiums, producing gross commissions of more than $7.8 billion.

With only 25 percent of banks and thrifts selling mutual funds and 20 percent selling annuities, financial institutions achieved $72.2 billion in 1997 investment sales, according to the Bank Insurance Market Research Group (BIMRG). This was a 28 percent increase over $56.5 billion in 1996, which, in turn, saw an increase of nearly 36 percent over 1995 investment sales. Likewise, bank annuity sales in 1997 were up 18 percent from $17.1 billion in 1996.

Fee Income for Sales of Mutual Funds and Annuities

Fee income from selling or servicing investment products like mutual funds and annuities totaled $3.72 billion in 1997, 39 percent higher than in 1996 and more than double investment-product fee income in 1994.

Although annuities were less than 22 percent of total investment-related sales ($20.2 billion of $92.4 billion), they represented approximately 30 percent of total investment fee income (an estimated $1.11 billion of $3.72 billion).

Total noninterest income at those financial institutions that sold annuities and/or mutual funds was $84.64 billion, up 9 percent from $77.54 billion in 1996. Among these banks and thrifts, fee income from these sales accounted for 4.4 percent of their noninterest income, up from 3.4 percent in 1996 and 2.8 percent in 1995.

Measuring potential bank insurance fee income

What share of the insurance market would the banking industry need to equal 1997's $3.72 billion of fee income from all investment product activities?

Assume the banking industry achieved a 15 percent share of the markets in personal lines insurance (auto and homeowners) and ordinary life insurance. This is not a fantastic assumption, given that banking has achieved a similar share of mutual fund sales and an even higher share of annuity sales.

In 1995 (the most recent year for which we have auto and homeowners insurance premium figures), sales of auto insurance for private passenger, liability, collision and comprehensive produced $104.2 billion in premium. Premium for homeowners insurance totaled $25.8 billion.

Assuming average commissions of 10 percent on a 15 percent market share, banks would produce annual commission or fee income of $1.95 billion on sales of auto and homeowners insurance. Over five years, assuming stasis in those markets and premiums, banks would earn revenues of $9.75 billion. This excludes potential income generated from the sale of other property-casualty products, personal or commercial.

According to the American Council of Life Insurance (ACLI), in 1996, single premium life (SPL) sales totaled $10.71 billion in premiums, and first-year premiums for ordinary life (OL) were $12.04 billion. Assuming a 15 percent market share in both these product lines, the banking industry would sell $1.61 billion in SPL and $1.81 billion in OL.

A 6.5 percent commission rate on SPL would earn banks $104 million annually or nearly $522 million over five years. Compensation of 100 percent of first-year OL premium (including commissions, agency overrides, expense reimbursement allowances, etc.) – not at all an uncommon amount outside New York State – would earn banks nearly $1.81 billion or $9.03 billion in first-year commissions over 5 years. Renewal commissions of 5 percent during years 2-5 would produce another $620 million in fee income. Over five years, total bank revenues on a 15 percent market share of new SPL and OL sales would amount to $10.172 billion.

Together, a 15 percent market share in new sales of personal lines, SPL and OL insurance would produce $3.86 billion in annual noninterest revenue for the banking industry. That amount, which does not consider potential revenues from sales of other life, health and property-casualty insurance products, exceeds the combined investment fee income banks derived in 1997 from gross commissions on annuity and mutual fund sales, trailer fees or commissions, and investment advisory fees. Together, new and renewal commissions would push insurance revenues over five years to $19.9 billion.

Selling insurance can add initially 2 to 4 percent to a bank's bottom line—and as much as 5 to 10 percent within 5 years, reducing a bank's impetus to take bigger credit risks.

How would these insurance revenues impact banking? With a 15 percent market share over two years, the commercial banking industry would earn $7.93 billion, an amount equal to 4 percent of the industry's total combined 1996 and 1997 noninterest income.

Acquisition costs of retail customers in recent bank mergers

In the five largest bank acquisition-deals of 1997, bank acquirers paid an average $2,500 per retail customer relationship, more than double the price paid five years ago. Accordingly, these banks must

generate additional profits of $150 to $250 per customer to earn an acceptable return at these prices. (A more recent Anderson Consulting study put the median premium paid per banking customer around $6,000. See *American Banker*, June 10, 1998.)

Based on average premiums for auto, homeowners and life insurance, a 30 percent penetration rate of a bank's retail customer base would conservatively produce, per customer, $345 in first-year revenue and another $75 of revenue in each of years two to five. Assuming a 40 percent operating profit in an industry with an average efficiency ratio of 59.15 percent, the $645 of insurance-related revenue over five years would result, on average, in nearly $258 worth of pre-tax profits per retail customer. That's more than enough to pay for the new customer-acquisition costs.

A 15 percent market share in new sales of personal lines, single premium life, and ordinary like insurance would produce $3.86 billion in annual noninterest revenue for the banking industry.

Just do it!

There are many ways to measure the potential of bank insurance sales. I've contrasted them here with current investment fee income, bank annuity income, total noninterest income, and the cost of obtaining new retail banking customers via bank acquisitions.

But their potential can be measured in other ways, too – against the total revenue produced and profit earned per customer or from other banking and nonbanking products and services. Bank insurance sales can be measured in terms of their impact on a bank's ROA, return on equity (ROE), net income, or growth in net operating income.

But no matter how the value of insurance sales to the banking industry is measured, the impact of insurance sales on bank revenues and earnings can be financially meaningful. Bankers only need the will to enter the insurance market, the determination to do so correctly, and the wisdom to tend the business for its long-term worth. The 20-year fight bankers have waged to obtain insurance sales powers can be justified only if bankers, in fact, sell insurance.

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