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The Economic Value of Selling Insurance to Bank Customers

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 net operating revenue from 17 percent in 1960 to 44 percent in 1999, community banks lagged significantly in this department. They must do more to grow their fee-based income.

In a recent 12-year period, 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 that 12-year period, averaging less than 3 percent annual rate. Meantime, assets of finance companies grew at about 8 percent, pensions and insurance companies at over 9 percent, and mutual funds at nearly 20 percent.

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

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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 with the passage of new bank insurance laws in some two-dozen states and the resolution of the Gramm-Leach-Bliley Act last November.

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 1999, bank annuity sales tallied $26.2 billion constituting gross commissions in excess of $1.5 billion, an almost sevenfold increase in twelve years. From 1990-99, financial institutions sold $156 billion in annuity premiums, producing gross commissions of more than $9 billion.

With only 23 percent of banks and thrifts selling mutual funds and 20 percent selling annuities, financial institutions achieved $131.3 billion in 1999 investment sales, according to the Bank Insurance Market Research Group (BIMRG). This was an 18 percent increase over $111.2 billion in 1998, which represented a doubling of 1996 investment sales. Likewise, bank annuity sales in 1999 were up 31 percent from $19.9 billion in 1998.

Fee Income for Sales of Mutual Funds and Annuities

Investment fee income (derived from selling or servicing investment products like mutual funds and annuities, trailer commissions or asset-based fees, or investment advisory services if banks managed those assets) totaled $5.28 billion in 1999, 19 percent higher than in 1998 and nearly triple investment-product fee income in 1994.

Although annuities were 20 percent of total investment-related sales ($26.2 billion of $131.3 billion), they represented close to 30 percent of total investment fee income (an estimated $1.57 billion of $5.28 billion).

Total noninterest income at those financial institutions that sold annuities and/or mutual funds was $116.7 billion, up 19 percent from $97.86 billion in 1998. Among these banks and thrifts, fee income from these sales accounted for 4.5 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 approach 1999's $5.28 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 1998 (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 $117.3 billion in premium. Premium for homeowners insurance totaled $29.0 billion.

Assuming average commissions of 10 percent on a 15 percent market share, banks would produce annual commission or fee income of $2.19 billion on sales of auto and homeowners insurance. Over five years, assuming stasis in those markets and premiums, banks would earn revenues of $10.95 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 1998, single premium life (SPL) sales totaled $15.28 billion in premiums, and first-year premiums for ordinary life (OL) were $17.49 billion. Assuming a 15 percent market share in both these product lines, the banking industry would sell $2.29 billion in SPL and $2.62 billion in OL.

A 6.5 percent commission rate on SPL would earn banks $149 million annually or nearly $745 million over five years. Compensation of 75 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 $1.97 billion or $9.85 billion in first-year commissions over 5 years. Renewal commissions of 5 percent during years 2-5 would produce another $676 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 $11.27 billion.

Together, a 15 percent market share in new sales of personal lines, SPL and OL insurance would produce $4.31 billion in annual noninterest revenue for the banking industry. That amount, which does not consider potential revenues from ordinary-life renewal commissions or sales of other life, health and property-casualty insurance products, represents 82 percent of the combined investment fee income banks derived in 1999 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 $22.2 billion.

How would these insurance revenues impact banking? With a 15 percent market share over two years, the commercial

banking industry would earn $8.75 billion, an amount equal to 4.1 percent of the industry's total combined 1998 and 1999 noninterest income.

Acquisition Costs of Retail Customers in Recent Bank Mergers

In the five largest bank acquisition-deals of 1997, a banner year for buying, 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. (Another study by Anderson Consulting 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 2-5. Assuming a 43 percent operating profit among commercial banks, which had an average efficiency ratio in first quarter 2000 of 56.77 percent, the $645 of insurance-related revenue over five years would result, on average, in nearly $279 worth of pre-tax profits per retail customer. That's more than enough to pay for the customer-acquisition costs of recent bank acquisitions.

Get in the Game!

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

But the value of bank insurance can be calculated in other ways, too. For the bank not acquiring another bank, new bank insurance sales can be measured against the total revenue produced or profitability earned per customer, or they can be compared to that produced by other banking and nonbanking products and services. Bank insurance sales can be measured in terms of their impact on a bank's growth in net operating revenue, its net income, ROA, ROE, and its cross-selling benchmarks.

But no matter how one measures the value of insurance sales to the banking industry, even the most conservative assumptions argue favorably that the impact of insurance sales on bank revenues and earnings can be financially meaningful. All that bankers need is 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 30-year fight bankers have waged since the Bank Holding Company Act was amended to obtain insurance sales powers can only be justified if bankers, in fact, sell insurance.

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