



No More Barriers...A Look at Financial Services Consolidation

Part 1

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No More Barriers...A Look At Financial Services Consolidation – Part 1

By Andrew Pfaff

Before discussing consolidation among financial services institutions, it is useful to take a brief look at industry consolidation from a generic perspective. The generic perspective provides an overview of the traditional driving forces behind consolidation in any industry. With the generic perspective in mind, it is easier to evaluate whether the factors causing the recent trend toward consolidation among financial institutions are consistent with those that have caused companies to consolidate in the past.

I. Industry Consolidation: General

A. Customer Satisfaction

Regardless of the industry, companies consolidate to improve customer convenience, choice, and overall satisfaction.

Through consolidation, companies can offer customers access to a wider array of products from a single source. By consolidating, they can use their existing distribution channels to sell a greater variety of products to their customers. While the goal is generally to increase revenue per customer, in many cases, consolidation increases the breadth of a company's distribution network and makes it easier for customers to access their products.

Citigroup is a good example of a company that has obtained a wider array of products and increased customer convenience through consolidation. By bringing Citibank, Travelers, and Salomon Smith Barney together under one roof, Citigroup can now offer banking, insurance, and investment products to its customers in a more efficient manner.

Along with providing access to more products, consolidation also permits companies to bundle products for their customers. Since bundling is a way for companies to satisfy customer needs while gaining pricing flexibility, it offers the convenience of "one stop" shopping coupled with the ability to gain a pricing advantage over competitors.

B. Diversification

Another key reason for consolidation is companies' desire to mitigate risk and stabilize financial performance through diversification.

Diversification can take many forms, such as product diversification or geographic diversification. Regardless of the form, though, diversification helps prevent negative events in one area of the business from having a catastrophic effect on the livelihood of the company as a whole.

Through consolidation, companies can add new product lines or new geographic regions that diversify the underlying forces that drive the business toward profitability. Ultimately, this reduces their vulnerability to factors that can cause poor financial performance.

Product diversification is at the root of the combination of Morgan Stanley and Dean Witter. Their union has created a firm with both institutional capabilities (sales and trading, investment banking and asset management capabilities) and consumer credit capabilities (Discover card brand). In contrast, geographic diversification is at the heart of the proposed merger of Ernst &

Young's consulting division with Cap Gemini. Ernst & Young has a strong domestic presence that is attractive to Europe-based Cap Gemini, and vice versa.

C. Efficiencies

Cost advantages or efficiencies are another reason behind corporate consolidations. By leveraging technology advantages, distribution capabilities, or other internal strengths, combining companies can deliver products at a significant cost advantage relative to competitors.

Today's mega-merger partners often cite planned synergies that will arise as they eliminate overlapping operations. In these cases, consolidation becomes a way to exploit cost reduction opportunities that will arise due to corporate infrastructure efficiencies. Sometimes, though, the efficiencies that arise from corporate consolidations can also produce bundled products and pricing strategies that provide the merged company with pricing advantages over individual products offered by competitors.

In the case of the 1999 merger announcement between Monsanto and Pharmacia & Upjohn, a driving force behind the merger was that the new company could achieve annualized savings of over \$600 million through cost avoidance and elimination of duplication. Similarly, the talk of a merger between German banking giants Dresdner Bank and HypoVereinsbank could yield more efficient branch operations that may lead to the elimination of millions of dollars of servicing costs.

D. Customer Base

Access to new customers is another reason that companies consolidate, as obtaining customer bases through consolidation can often be quicker and more cost effective than building these customer bases from scratch. In these situations, the acquiring company generally wants to obtain new customers with similar characteristics to their own, as they would be good targets for cross-selling efforts.

Managed care companies and HMO's are continually acquiring one another in order to increase their membership. For example, Wellpoint Health Networks recently acquired Rush Prudential Health Plans of Illinois. The deal doubled Wellpoint's medical membership in Illinois.

E. Competitive Advantage

Industry consolidation can also be driven by a company's desire to obtain the missing pieces of their competitive puzzle. These pieces could be almost any of the characteristics that a company feels are essential to its success (e.g. certain technological competencies, mastery of specific market niches, etc.). To obtain these missing links in an expedient manner, companies often choose to acquire other firms in the industry with a proven track record in the area of interest.

The 1996 merger of Aetna Health Plans and US Healthcare exemplifies this type of consolidation. In order to survive in the managed care world, Aetna recognized that it needed to have a strong presence in the HMO market. Without the time or expertise to build an HMO presence from the ground up, Aetna was forced to acquire these capabilities by merging with a proven leader in the HMO market.

II. Industry Consolidation: Financial Services

A. Customer Satisfaction

Opponents of financial service industry consolidation warn that newly formed financial service behemoths will prove detrimental to customers. They fear that fees will increase, service will decrease, and customers will suffer from the disappearance of personal relationships with neighborhood bankers, brokers, and insurance agents.

We believe that, while further consolidation is likely to yield new conglomerates with imposing size (like Citigroup), the impact on customers is unlikely to be devastating. Even in the most extreme consolidation scenario, free markets will ensure that customers still exert an important influence in the marketplace. As has happened during previous periods of deregulation, if customers are sufficiently dissatisfied with the treatment they receive from consolidating financial service providers, new service providers will exploit the service gap. The result will be the emergence of new community-based, specialty providers that will cater to customer needs and steal market share from the big conglomerates.

On the customer service front, the likeliest result of consolidation should be improved "one-stop shopping" convenience for financial products. Customers in today's financial service marketplace typically maintain separate relationships with insurance agents, bankers, and brokers or investment advisors. With each relationship come separate billing statements, account summaries, phone numbers, fax numbers, office hours, and e-mail addresses.

Consequently, most consumers find that keeping track of their financial service products is both cumbersome and inefficient; it is often difficult for customers to create a complete and accurate picture of their financial situation. Horizontal industry consolidation should benefit customers by reducing the number of relationships they must maintain with financial service providers.

B. Diversification

Diversification benefits should be examined closely by consolidating financial service providers. Intra-sector consolidation mainly provides geographic diversification. For instance, banking mergers might involve companies from different locales in order to reduce the impact of an economic downturn in a particular region. Similarly, insurance mergers might involve companies with exposures in different parts of the country in order to reduce the impact of a natural disaster in one particular region.

While this diversification is important, cross-sector consolidation across the financial service industry provides different and potentially broader benefits. It involves new forms of cross-pollination among banks, insurers, and brokerage firms, with companies from different sectors taking the opportunity to enter one or many other sectors. From a diversification perspective this is important because companies begin to offer products from a fresh market perspective, often driven by factors completely different from the drivers of their traditional product set.

Cross-sector diversification, therefore, stimulates innovation and stabilizes long-term industry performance. For instance, insurance performance is driven largely by non-economic factors (natural disasters, catastrophic events, etc.) while bank performance is typically driven by economic factors (interest rates, inflation, etc.). It is easy, therefore, to imagine the benefits of combining insurance and banking operations within the same company.

C. Distribution Channels Efficiencies

With consolidation across sectors in the financial services industry, the potential for companies to bundle multiple types of financial service products (insurance, banking and brokerage) becomes a reality.

Consolidated distribution channels are integral to increased customer convenience as they provide customers with the ability to purchase multiple financial service products from a single source. Existing intra-sector physical distribution networks among insurers, banks, and brokerage firms provide a good foundation for the distribution of products from other sectors as well. As such, distribution channel consolidation among insurers, banks and brokerage firms is an opportunity for merging firms to increase revenues while leveraging the expanded cost advantages of multi-product bundling.

Along with one-stop shopping, financial services consolidation provides incentives for companies to bundle packages of products that target discrete customer segments. Today, it is not uncommon for an insurance company to bundle products like general liability insurance, auto insurance, and worker's compensation coverage for a commercial customer. Banks bundle products when they combine offerings like payment services and lines of credit for business customers. In both cases, as a result of efficiencies gained by selling multiple products via a single customer interaction, bundled products are generally offered at a lower cost than if each component were purchased separately.

D. Customer Bases

While customer base expansion should not be considered a primary driving force behind financial service industry consolidation, it is the inevitable outcome of inter-sector consolidation. As distribution costs decrease through consolidation, it will become easier to reach more customers with more product.

Within newly merged organizations, cross-selling opportunities should be relatively easy given the strong affinity that exists between products that help customers manage financial risks, cash flows and investments. Consolidating financial service providers will make the natural move toward customer expansion by first cross selling to their existing, expanded base. They will then utilize their widened distribution channels to reach new market segments and customers.

E. Competitive Advantage

Achieving greater size and diversification through consolidation will enable financial services firms to operate more efficiently and invest in better technology. These factors will make product bundling and lower pricing more achievable, thereby enabling these firms to stay competitive.

As the pressure to keep pace with rivals in a rapidly changing industry drives financial services companies toward consolidation, pure size and scale become increasingly important. As the one-stop shopping model becomes the dominant mode of business operation, the pressure to add new products and services will force many firms to consider mergers, acquisitions, and partnerships. By increasing in size by several orders of magnitude, firms increase the assets they manage and increase their total market capitalization. These factors help them be viewed as industry leaders and potential acquirers rather than targets.

F. Customer Information

In financial services, all the previously discussed driving factors for consolidation exist. In addition, the importance of obtaining a more complete picture of a customer's financial information is an added incentive for consolidation. Among insurers, banks, and brokerage firms, the close relationship between the elements of customer data that are collected (e.g. a person's net worth has a huge impact on insurance needs) make consolidation an attractive option. Therefore, from both a cross selling and a customer service perspective, having a complete picture of the customer creates a significant competitive advantage in financial services.

G. Privacy Concerns

Some privacy advocates fear that consolidated companies engaging in a wide range of financial services activities will have the ability to use customer information improperly. For example, these firms could check customers' bank balances or medical histories before approving them for insurance policies. While this type of information sharing is theoretically possible, it is important to note that it would require information systems far superior to the ones that exist today in the financial services industry. Moreover, certain points in the financial services legislation require companies to fully disclose any information sharing that will occur. With the proper checks and balances in place, it is more likely that customers will benefit from the expanded customer information that financial services companies will have in their portfolios.

III. Conclusion

In conclusion, it is evident that the recent wave of consolidations among financial institutions has been driven by many of the same forces that have led to consolidation in other industries. These forces are real and they can create significant benefits for financial institutions that embrace the consolidation trend. For this reason, the trend is expected to continue and probably even gain momentum in upcoming months. For customers of financial products, increased consolidation should be viewed as a positive sign in an industry marked by fierce competition among rival companies. The result should be an improved customer experience in terms of product offerings, efficiency, and responsiveness as the best firms raise the bar in servicing their customers and the rest ultimately disappear from the industry landscape.

About the author: Andy Pfaff is a Senior Consultant with the Madison Consulting Group. He resides in Manhattan with his wife and one-year-old daughter. Currently, the Pfaff's own 28 separate financial products provided by 14 different institutions.

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