



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

Part 2

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I. Trends: Financial Services

A. Recent Trends

Despite shifts in assets from traditional savings and checking accounts to securities throughout much of the 1990's, the more popular financial products like credit cards and mutual funds do not always generate the best profitability. In fact, basic products like checking accounts, trust accounts, and ordinary life insurance still provide huge industry profits, with nearly half of all personal financial services industry profits coming from checking accounts, savings accounts, CD's, and bank money market accounts. In order to survive, diversified financial service companies must make these traditional products work for them. Typically, cash generated by products dwindling in popularity can be used to fund innovation and growth and support earnings. In turn, strong earnings and stock prices allow companies to retain control over their own destiny as industry consolidation accelerates.

In many cases, "sexier" financial service products offer only modest profitability. Take credit cards for example. Banks have rapidly introduced new benefits such as reward programs. While these benefits increase balance growth, they also cause many households to segment their usage among several credit cards. Also, credit card companies have begun to court previously undesirable (high-risk) customer segments. As a result, much of the value of credit card innovation is passed onto the consumer while competition increases and new entrants to the market arrive. This causes downward pressure on fees and profits, while delinquencies and customer acquisition costs rise. As a result, a shake out of the credit card market can be expected as one of the forces driving consolidation.

Similarly, the mutual fund industry has introduced previously unknown products and services such as index and international funds at little cost to consumers. While the innovation led to an increase in the percentage of households owning funds, the subsequent growth in the industry has attracted new competition that has kept margins narrow in traditional money market, bond and equity funds.

B. Future Trends

In the future, as customers continue to substitute higher yield, lower cost products for less attractive alternatives, they will also migrate toward remote distribution channels such as the PC, ATM, or telephone. In the short term, face-to-face distribution channels will continue to dominate, but this will change over time. The industry will continue to consolidate, with larger, better performing companies controlling their own destiny and the smaller, poorer performers becoming targets. Economic health will continue to be a big factor, since much of the industry's performance is based on asset appreciation, interests rate spreads, and consumer confidence. A market decline, a drop in spreads, or credit crunch could significantly deflate industry profitability.

To maintain profitability, companies will look to expand into foreign markets. In doing so, it will still be important to maximize profits from traditional products while developing new business. Disciplined cost and productivity management, customer retention and deepening of high value customer relationships will also be critical. In addition, attracting and developing top-tier

managerial talent will permit cash generation from traditional businesses to create a viable platform for consolidation.

Because so many mergers have already taken place, traditional global players feel pressured to combine. They've seen many smaller firms that they used to dominate merge with others and the new entities are rapidly becoming viable competitors. While financial services consolidation has taken place for several years, there is still more to go, and by the end, some predict that there will be only a dozen broad spectrum financial services firms available. Now that banks, brokers, and insurers are free to combine, most experts believe that the big banks (i.e. those with the most assets) will be the winners. Other winners could be smaller, technology savvy players like Charles Schwab and A.G. Edwards.

II. Consolidation: Banking Perspective

A. Incentives to Enter Insurance

Banks are eager to diversify into new financial sectors, and they will likely do so through insurance and related businesses like asset management. Many commercial banks and investment banks find insurers' weaknesses to be attractive business opportunities. They view owning an insurance company as a way to expand assets under management and cross-sell banking products to a different customer base. For instance, if banks can cross-sell insurance and banking products, they can achieve major savings relative to insurers who operate through brokers. The ability to control distribution costs better than insurance companies will allow banks to obtain better rates of return on insurance products offered through them. Also, because they have superior data management and information systems capabilities than insurers, by entering the insurance business, banks can leverage these capabilities to outperform insurance companies.

Broaden Product Base: Ultimately, banks want their customers to have access to a broad portfolio of financial services from one institution. Therefore, for banks with a large customer base, the ability to provide more financial products is an attractive inducement to enter additional financial sectors. Expect banks to offer personal lines commodity insurance products that are fairly standard and do not involve sophisticated information from customers. Many industry observers believe that, like credit card and mortgage products, banks can successfully sell specialized insurance products to their large customer bases. While banks are most likely to succeed with products that are closely related to bank transactions, like title and mortgage insurance, annuities and life insurance could also become popular products.

One possible way in which banks can attract potential customers from insurance companies is to offer services such as the ability to transfer premium payments directly from customer accounts. This type of convenience provides banks with an advantage relative to the way insurance companies operate (i.e. via check payment).

Targeted Underwriting: Banks entering the insurance market will try to improve their returns by creating more focused underwriting. Banks will view insurance companies in a "modular" fashion instead of looking at the entire company, thereby permitting them to focus on the insurance business lines that are the most profitable. By not being constrained by an existing insurance company structure, they will be able to build or buy a particular insurance business if it's particularly attractive to their risk appetite.

Banks are also likely to consider the reinsurance business because they see it as similar to the types of financial products they already sell. They may buy or establish their own reinsurers, and by doing so, achieve greater capacity and lower prices.

B. Disincentives to Enter Insurance

Today, the jury is still out on whether banks can sell insurance, and many experts feel that it is hard to prove that synergies do exist. Detractors of consolidation claim that cross-selling insurance isn't a realistic banking strategy because it requires a dedicated sales-force that banks simply don't have. Instead, these analysts feel that consolidation will entail banks aligning with insurers and referring business in exchange for a piece of the commission. To support this opinion, they point out that few European banks have gone beyond selling annuities, which most people view as an investment vehicle packaged as insurance. In this scenario, any increase in revenue for banks would be marginal, and it would be difficult to cost-justify significant acquisitions of this nature.

In the US, despite recent mergers and acquisitions, banking and insurance remain largely separate businesses. Cultural differences play a large role in keeping the businesses apart. While insurers are more accustomed to taking risks, banks tend to be more deliberate and bureaucratic in their decision-making. As a result, though many banks are buying insurance agencies, they frequently have no plans to integrate the agency into the bank. Technically, this type of acquisition should not be considered consolidation, as consolidation would entail meeting the insurance needs of bank customers in unique, efficient, and more profitable ways.

In spite of the apparent benefits for banks entering insurance, very few life or property/casualty companies have sustained the level of returns that bank's value. Furthermore, property/casualty companies come with catastrophic risk, and on the life side, banks are not generally comfortable with actuarial risk. As a result, banks may be reluctant to acquire insurance companies unless they meet specific strategic criteria.

C. Approaches to Enter Insurance

Most observers agree that deregulation will impact life insurance before property/casualty insurance. By and large, banks don't have an appetite to underwrite property/casualty business. The major reason: banks are not comfortable with the volatility associated with these companies.

Likely Acquisition Targets: Instead of buying property/casualty companies, expect banks to buy life insurance companies, as the product fit is better. If they choose to venture into property/casualty, banks will likely be more interested in personal lines companies than commercial lines companies. Insurance companies that are particularly strong in annuities and life insurance (i.e. products that resemble bank deposits) will also look attractive. In spite of the good product fit on the life insurance side, a key issue for banks may be their ability to mass market life insurance profitably. It's possible that life insurance products may need to be redesigned to better fit into bank's distribution channels.

Buy An Insurance Agency: A second approach is for banks to buy established insurance agencies. In fact, recent trends show that midsize banks in many states have acquired independent insurance agencies. One advantage banks have in purchasing insurance agencies is that larger banks have more leverage to get the best deal. As stand-alone entities, many insurance agencies are not able to obtain the commission levels that banks can get.

Buying insurance agencies also allows banks to focus on distribution while leaving production to existing underwriters. Moreover, it can provide banks with new banking client relationships.

Build From Within: A third approach for commercial banks would be to develop their own operations instead of buying insurance companies or brokerages. Why develop on one's own? Buying a large insurance company or brokerage would be expensive, cultures may not mesh easily and, in the case of life insurance, it could be difficult to purchase an agency as a result of the product's commission structure. Most of the commission is paid up front on the policy, so valuing the "revenue" stream is difficult.

While some industry observers believe that the most realistic approach for banks will be to align themselves with an insurance company or agency and refer business to them in exchange for a piece of the commission, a bank may have a customer base that is desirable yet undervalued by insurers. In such cases, banks might create their own insurance company by forming a joint venture operation with an existing insurance company. By simply obtaining an insurance license, a bank make money as the middleman that helps its clients find an agency or company that can provide insurance. Alternatively, if the bank were to become an agency itself, then it could make money by earning a full commission.

Target Market: As banks look to buy insurance companies, they are most likely to target domestic middle market companies with annual sales of \$500 million or less. Above that level, banks would be competing with the major insurance brokerages that possess global coverage, unique market access, and in-house expertise. The middle market, however, is a segment in which large brokerages have often failed to compete successfully, as they tend to have difficulty in dealing with what are very personal, small-scale relationships by their terms.

III. Consolidation: Insurance Perspective

A. Threat of Takeovers

Among insurers, the repeal of Glass-Steagall is creating a scramble to merge, get big, increase market share, and raise profits. The prime targets - insurers with a lot of cash, sluggish performance, and relatively small size. Typically these are mid-cap insurers with market valuations up to \$10 billion. They are big enough to be worthwhile acquisitions, but small enough that they can't afford the technology investments required to boost their share prices.

In particular, mutual insurers need to go public to be able to use stock as tender in mergers, takeovers and options to reward executives. Without doing so, they are powerless to compete in the consolidating marketplace. For example, John Hancock and Prudential, both mutual companies, have not traditionally been subject to stockholder pressure with respect to earnings. As a result, their returns are meager relative to publicly traded companies, making them attractive takeover targets. In response, both have announced plans to go public.

Most acquirers of US insurance companies feel they can run them more efficiently with less staff. These include European banking/insurance firms that already have substantial US holdings such as Allianz of Germany, AXA of France, ING and Aegon of The Netherlands and Belgium-based Fortis. Potential strategic combinations might include property/casualty insurers and consumer credit companies such as mortgage lenders and auto-finance houses. The best long-term fit, however, may be between retail banks and life insurers. Both are in the investment business, and bank branches and insurance agents can readily sell each other's products.

Additional threats to insurers will come from brokerage firms, as several large brokers (Merrill Lynch, Paine Webber, and Fidelity) already own small insurance companies. Brokerages will likely try to marry these subsidiaries with the expertise and scale of a major insurer to obtain some real benefit out of those operations. In addition, since selling annuities requires securities industry licensing, insurance companies with a strong presence in annuities may be viewed as good targets for acquisition by brokerage firms.

B. Keeping Pace with New Competitors

For insurers to survive in the same market as banks will require them to become more innovative and aggressive. For the most part, insurance companies are viewed as poor performers compared to other financial services companies, and in a marketplace with no boundaries, they could face serious trouble.

Traditionally, the insurance industry has remained tied to age-old definitions of insurable risk. Experts believe that to prosper amid new competition, insurers must "think different" with respect to the kinds of risks that can be insured. In many cases, homogeneous or predictable exposures and other traditional defining characteristics of risk are outdated. The new paradigm updates this thinking by stating that if a risk is understandable, measurable, and manageable, it is insurable.

Possibly the most significant impact of financial services integration on the insurance industry will be the lowering of delivery costs resulting from the entry of providers that operate more efficiently. For instance, banks entering insurance will make the industry more aware of its cost basis. Consequently, agents and insurers will be forced to reduce their costs in order to compete. Ultimately, for agents to survive in competition with banks, they will have to emphasize relationship building with policyholders.

C. Opportunities for Insurers

Instead of remaining overcapitalized in order to achieve high credit ratings, insurance companies would do more to boost their ROE by affiliating with banks. Banks already have much of the technology and facilities that insurance companies need, so such combinations would offer substantial cost savings.

Bank Partnerships: Partnering with banks is an excellent opportunity for insurance companies and agencies to expand their commercial and personal line customer bases. Banking combinations give agencies' improved access to automated product distribution and enable insurance companies to establish multiple distribution channels. Banks have greater customer loyalty than insurance companies, and they can provide agents with solid, well-timed leads (e.g. - if a person is buying a home and applying for a mortgage, there's a strong likelihood they're also buying homeowners insurance). In addition, banks' broad consumer credit data can provide good predictors for insurance eligibility. These partnerships will lower the insurance agency's cost of marketing and distributing its products.

Affiliation Structure: Affiliations between banks and insurers can take various shapes - an outright sale of an agency to a bank, a partnership, or joint venture between insurance agents and banks. As previously mentioned, it is widely accepted that banks provide a viable marketing channel for many insurance products.

Most experts agree it's unlikely that insurance companies will begin to buy banks. Banks have high price/earnings multiples that make it almost impossible for insurers to acquire them. As an alternative, several insurers (State Farm and AIG notably) are easing into banking by obtaining thrift charters. Among strong insurers, AIG may be one of the few with the financial strength to contemplate a bank takeover.

While a bank joint venture might work for independent agents, they should also establish alliances with other financial service providers such as mortgage brokers, realtors, and financial planners – wherever there are synergies that can help build clientele.

IV. Consolidation: Brokerage Perspective

A. Merger Environment

With virtually all barriers to competition removed, commercial and investment banks are now free to combine their talents. Many believe their formula for success will require increased size. By combining, the new institution will obtain better access to capital, individual investors, and international markets. As an added incentive to globalize, pension plans and government owned companies in Europe, South America, and Japan are increasingly becoming privatized

Most industry analysts believe that the largest firms have the capital and market prowess to control their destiny. They dominate the market for debt and equity underwriting and they have no trouble making bridge loans. These firms include Merrill Lynch, Goldman Sachs, and Morgan Stanley Dean Witter.

As corporate clients more often prefer to deal with a single financial advisor for all their capital needs, firms that do not offer “one-stop shopping” will be at a competitive disadvantage. Given the merger wave of the last few years, the remaining players are either small regional houses or Wall Street's biggest firms. The smaller, unattached or lesser-powered securities firms will have to combine to survive or risk losing their largest clients to firms that can provide the services they require.

B. Opportunities with Commercial Banks

Brokerage houses have enjoyed strong performance in the past decade, largely as a result of baby boomers in prime income-earning years taking advantage of the strength of the stock market. While times have been good, these firms are facing sizeable investments in distribution technology to support retail brokerage. This increases the attractiveness of consolidating with a large commercial bank that has access to seemingly unlimited capital.

Grow or Die: Smaller securities firms, though, have large capital needs, particularly when they are advising on an acquisition in which they are expected to provide bridge financing until the client raises equity or long-term debt at a later date. Teaming with a bank can provide these firms with the capital they need to be more aggressive in winning deals. The result - there is no lack of desire to be acquired and, with commercial banks that have the capital, the willingness, and the approval of the Fed, even Wall Street's largest securities firms may not be able to remain independent for long.

Equity Expertise Required: Conversely, while commercial banks have made progress in debt underwriting, they still lack the expertise and ability to underwrite stocks. Some banks have tried

to build equity shops, but most have found that they could not easily build up the required skill set. They don't have the culture on the equity side and the marketplace won't give them the luxury of time. For a commercial bank, then, the ability to acquire a securities firm represents more than just adding another product to its inventory – it represents a desirable, required skill set that will fill a strategic growth need.

High-level Contacts: Without a doubt, equity underwriting capabilities are critical to long term survival. It brings with it CEO-level contact that mere lenders will never enjoy. In most cases, a CEO won't include commercial bankers in strategic discussions such as planned acquisitions, potential asset sales, or pending IPOs. Securities firms, with their strong research and trading operations, are able to present their clients with ideas in all of these areas.

Cultural Differences: The merging of two different cultures - particularly when it comes to compensation and tolerance for risk - will always be very difficult for banks and securities firms. Acquiring banks, therefore, must be absolutely clear about their post merger strategy, since a critical element of post-merger success is getting the highly talented and mobile brokers to make a long-term commitment to the merged company.

C. Consolidation: More to Come

Even before the official repeal of Glass-Steagall, the idea of consolidation among financial institutions was gaining momentum. With residual regulatory barriers still preventing some forms of consolidation, we saw the creation of merged firms with the size and scope of Citigroup (combining Citibank, Travelers, Salomon/Smith Barney), Morgan Stanley Dean Witter Discover, NationsBank/BankAmerica (which also includes Montgomery Securities), SBC Warburg Dillon Reed, CIBC Oppenheimer, and Deutsche Bank (overtaking Bankers Trust with BT Alex.Brown). With the last of the regulatory restrictions removed, the financial services landscape is even more wide open today and the probability and the possibilities for additional consolidations are almost unlimited.

Observers are eager to see what will happen to the large Wall Street firms that trail the big three (Merrill Lynch, Goldman Sachs, and Morgan Stanley Dean Witter) in size. These companies - Lehman Brothers, Bear Stearns, and Paine Webber - could all be potential targets for a large commercial bank. Of the three, Lehman Brothers (in spite of recent financial and management problems) would be the most difficult to acquire because of its capital structure. Bear Stearns and Paine Webber, despite strength in certain specialties, may have limited appeal because they lack strength across the board. Donaldson, Lufkin & Jenrette consistently maintains that it is not for sale, but in the current environment of consolidation, it appears that almost anything can happen.

From a different perspective, it will be interesting to see if any of them choose to acquire reinsurance companies. Goldman Sachs, Lehman Brothers, and Morgan Stanley Dean Witter in particular already have bond packages that operate in a way similar to some forms of insurance. For these firms, the acquisition of a reinsurer would create a natural fit.

In the insurance industry, the firms most attractive to potential buyers, and therefore are at the greatest risk of takeover, are high quality, mid-cap insurers. One mid-cap, Allmerica Financial, is strong in homeowners and auto insurance and also sells life and annuity products. They have achieved success primarily by selling to customers through financial planning seminars. Another

mid-cap, Reliastar, is well known for its success with life and annuity products. Both could be attractive targets for number of different types of firms.

Larger insurance carriers such as Prudential or Metropolitan Life might look to acquire such mid-sized companies in an effort to bulk up quickly. On the banking side, a large commercial bank (e.g. Wells Fargo) interested in entering the insurance industry might also be interested. Brokerage firms with existing insurance operations (e.g. Merrill Lynch) might also take an interest if they desire to increase the scale of their existing insurance operations.

A closer look at the insurance industry reveals a long list of potential takeover targets, including well-known insurers like American General and Jefferson Pilot. Lincoln National, a firm that excels at asset management, estate planning, and retirement sales could also be considered an attractive target. Mutual fund companies like Charles Schwab or T. Rowe Price could be interested in acquiring Lincoln's skills in order to service their mutual fund customers as they get older.

Insurers with depressed share prices are also vulnerable to larger insurance companies. Hartford Financial Services, with its auto, homeowners, and commercial lines products could also become the target of stronger insurers like AIG or Metropolitan Life. And, just recently, slumping Aetna Incorporated, with its huge managed care division, international group, and successful retirement services business was targeted for acquisition by Amsterdam-based ING Group and Wellpoint Health Networks.

V. Conclusion

With the playing field wide open and Y2K concerns in the distant past, financial institutions of all types and proportions are sizing each other up and evaluating one another with a predator/prey mindset. How their next moves will reshape the face of the industry still remains to be seen, but all indications point toward increased consolidation in the months to come. While more consolidation seems to be a foregone conclusion, the ability for these newly combined financial giants to compete effectively is still very much uncertain. As companies increase in size and complexity, they will be increasingly disadvantaged with respect to controlling costs and responding to market needs. Overcoming these disadvantages will be critical to survival and success in a technology-centric marketplace.

About the author: When Andy Pfaff joined the Madison Consulting Group, he was the first employee who had not previously worked at Bankers Trust Company. Andy previously worked as an internal consultant at Aetna Health Plans.

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