

# BANK DIRECTOR

THE PUBLICATION FOR DIRECTORS OF FINANCIAL COMPANIES

## in **Banks Insurance:** *Acquisitions,* **Growth,** *and* **Measures of Success.**

by **JOHN M. WEPLER, TOM LINN, AND PATRICK T. LINNERT**

**THE ACQUISITION** OF AN INSURANCE BROKER OR AGENCY DOES NOT AUTOMATICALLY TRANSLATE INTO AN INTEGRATED PROGRAM THAT WILL MEET THE NEEDS OF THE BANK'S CORE CUSTOMER BASE. THIS FIVE-YEAR RETROSPECTIVE SHOWS THAT LEARNING TO SUCCESSFULLY CROSS-SELL IS THE NEXT FRONTIER OF BANKS IN INSURANCE.

**H**ALF A DECADE AGO, scores of bank boards were persuaded that the holy grail of fee income was the lucrative business of insurance—and throngs of institutions rushed forward to acquire agencies or to grow an agency business from within.

Five years later, have banks failed or succeeded in insurance? There is much evidence to support that banks have, in fact, succeeded, and this article will outline the performance of bank-owned agencies, market trends, acquisition pricing, and strategies employed by the nation's leading banks as well as areas that need improvement. In addition, it presents bank board members with questions they should ask to evaluate their existing strategy. Finally, for those institutions that have not yet entered the arena, this article will provide clarity so that the board can intelligently decide whether there should be a commitment to enter the insurance distribution system.

#### **Overview**

In 1999, the passage of Gramm-Leach-Bliley (GLB) broke down the walls separating banking and myriad other financial services. Financial institutions were quick to identify insurance distribution as an area with the potential to generate strong returns coupled with high stability and predictability. By contrast, the insurance underwriting market was generally viewed as a business segment with low margins and high volatility. As a result, the vast majority of the momentum in the past five years has been with the acquisition of insurance agencies and brokers by banks. (The two terms, “agency” and “broker,” should be considered synonymous within the context of this article.)

Some grandfathered banks and others with favorable state legislation were already in the insurance brokerage business prior to GLB. Since the passing of GLB, a tidal wave of bank/agency acquisition activity has altered the landscape of insurance brokerage distribution. Banks have aggressively entered this marketplace for four main reasons:

*Expansion of noninterest income*—Insurance has been incorporated as a meaningful component to a broader strategy to diversify net-interest-rate margin risk by building noninterest income.

*Expansion of wallet share per customer*—Evidence supports the theory that increasing the number of products per customer will measurably enhance customer retention and, in turn, protect the bank from competitive incursions into the existing bank customer base.

*Expansion of earnings per share*—Acquiring a profitable insurance brokerage operation with critical mass, recurring commission revenue, and high customer retention adds to earnings growth, as measured by accretion to GAAP earnings per share.

*Expansion of market share*—Leveraging the acquired insurance platform to acquire local agency books of business, particularly those that include policyholders who are not current customers of the financial institution, will expand market share. These new policyholders become targets for cross selling loan and deposit products in order to complement and accelerate the rate of return on other capital investments made by the financial institution to expand market share.

Now, five years after the passage of GLB, information is available to better define the bank insurance distribution landscape. Bank boards considering insurance or evaluating their insurance distribution platform are now in a position to critically evaluate the success of the front runners. Banks leading the charge are using insurance distribution as a core component of a broader strategy to expand non-interest income, wallet share per customer, earnings per share, and market share.

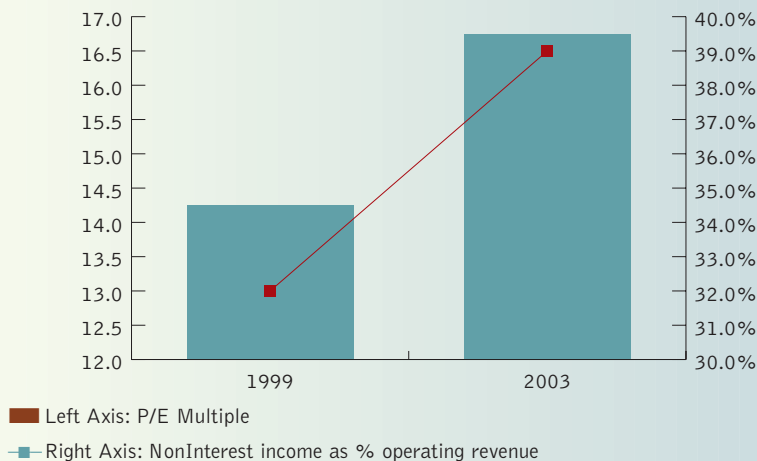
#### **Noninterest income**

Most banks realize that to compete effectively today and drive higher P/E multiples, they must search for ways to diversify their net-interest-rate margin risk by increasing noninterest income. Adding an insurance component has allowed many institutions to accomplish this strategy as well as create additional wallet share per customer and enhance customer retention.

A fundamental question often asked by bank board members is, “Will entering the insurance arena enhance the overall P/E multiple of the bank?” It is difficult to determine whether the decision to execute an insurance strategy alone will have a material influence on a bank's P/E multiple beyond simply enhancing noninterest income. But banks with significant insurance brokerage revenue did experience a 16.1% increase in their average P/E multiple from 1999 to 2003 at the same time noninterest income as a percent of revenue grew 19.2% (see Figure 1). Even more compelling, 20 U.S. banks with assets closest in size to the median of banks with significant brokerage insurance revenue had a 2003 P/E multiple of 16.0 times, or about 4% less than banks in insurance. While factors other than maintaining a sizable insurance operation obviously have a much greater influence over bank valuations, it appears that insurance can be a meaningful contributor to the expansion of noninterest income, which will continue to have a positive influence on P/E multiples.

#### **M&A activity**

Banks have aggressively and successfully entered the insurance distribution arena by acquiring insurance brokerages that specialize in the distribution of property, casualty, and health insurance. From 1999 through 2003 there were approximately 986 publicly announced insurance brokerage

**FIGURE 1****Banks with Significant Insurance Brokerage Revenue**

Source: SNL Financial

transactions. Public and private brokers consummated approximately 40% of these deals. Banks and thrifts were a close second, accounting for 35% of the total. Insurance companies and “other” (i.e., real estate firms, financial services firms) rounded out the list of acquirers during the past five years.

Successful banks entered the marketplace by first identifying the highest-performing foundation agency within their core market territory and paying a premium to acquire quality. Next they began pursuing additional foundation acquisitions in other regions to fill out the bank footprint and customer base. Subsequent, fold-in acquisitions brought about an increase in critical mass, per insurance regional profit center, and, therefore, an increase in operating margins. Banks with a more mature insurance operation acquired out-of-footprint insurance agencies as well. This strategy has enabled these banks to secure additional insurance talent and lines of business specialties, and to drive bank expansion into new territories.

In the past five years, there has been a steady increase in the number of committed buyers focusing on larger acquisition targets. According to SNL Financial, the average transaction value in bank/agency deals increased from approximately \$2 million in 1999 to \$10 million in 2003. Deals closed in 2004 are estimated to average over \$15 million in transaction value. Driving this trend is the realization that success in insurance depends largely on acquiring quality agencies that can contribute a meaningful revenue volume to insurance underwriters and employ a large, institutionalized production staff.

The number of acquisitions closed by banks declined in 2001, largely resulting from deal structure complications created by the termination of pooling-of interest accounting. It picked up in 2002 but waned in 2003, mostly because of the resurgence in interest in the bank-to-bank arena (see Figure 2). Although bank transaction opportunities in 2004 will continue to divert the attention of many banks, the number of bank agency deals should increase as well. While many banks have indicated that activity in the fourth quarter may be derailed as a result of reporting requirements caused by Sarbanes-Oxley, a marked increase in the planned insurance acquisition activity by both banks and credit unions should result in an increase in bank/agency deals closed in 2004. At the 2004 Bank Agency NetworK (BANK) Summit, the nation’s leading bank insurance executives indicated conclusively that their acquisition activity will gain momentum in 2004 due to deals in process to purchase insurance brokers, both in and out of the bank footprint. Further, the amount of time it takes to close insurance transactions has shortened considerably as banks now have a better understanding of the business. Boards have become more comfortable endorsing aggressive insurance expansion after witnessing the financial success of acquired insurance brokers.

Looking ahead, the key factor will be quality. Competition is fierce for quality agencies and the acquisition playing field undoubtedly will become more intense in 2004 and 2005. Public brokers, which are closing deals at a record pace and aggressively pursuing additional targets, will prove to be formidable acquisition competition for banks. This activity is due to softening insurance premium rates, mediocre organic growth by brokers, and normal demands by shareholders to advance earnings and maintain historical revenue growth.

#### **Growth and profitability**

Banks have attained significant revenue growth in insurance and now constitute a major component of the insurance distribution system. As reported by *Business Insurance* in 2003, 23 of the top 100 largest U.S. brokers (and six of the top 25) were bank owned in 2003. Banks represented only seven of the top 100 in 1998. Statistics available later this year will confirm further penetration, given acquisitions closed in 2004. Figure 3 illustrates most of the banks with sizable insurance brokerage operations. While a portion of the bank insurance revenue for a few of the banks listed includes insurance other than brokerage revenue, the primary revenue for the majority of banks on the list consists of property and casualty and life and health brokerage business.

Bank-owned agencies are leading public brokers in total growth. While outperforming both public brokers and

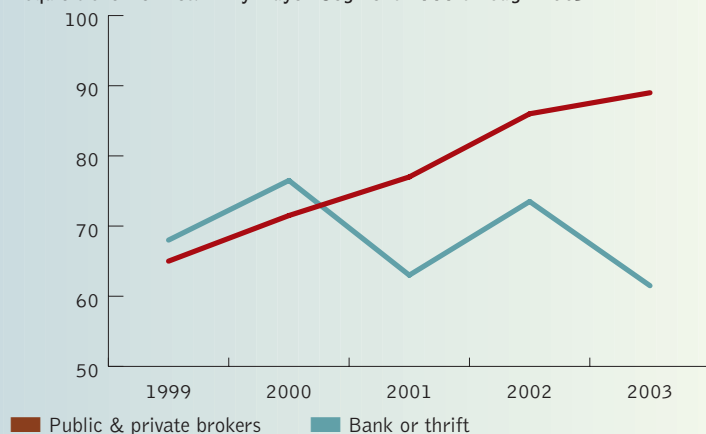
banks in organic growth, large, independent agencies have fallen short in acquisition growth, due to balance sheets that are deemed inadequate to support the upfront consideration required by most sellers. Large independents have attained strong organic growth due to a diversion of short-term profitability to improve sales training, sales management, referral management, incentive compensation, value-added services, and to fund perpetuation requirements.

A portion of the organic growth within each type of insurance distribution segment includes a revenue lift in 2003 from insurance companies' raising premium rates. Bank-owned agencies achieved actual organic growth of 11.5% in 2003 (see Figure 4). However, organic growth would have totaled 7.5% had 2003 been a flat-premium-rate environment. Banks recognized that the historical rates of commission growth achieved by target brokers were favorably influenced by rate increases and appropriately factored the market cycle into deal pricing and structure. By our estimates, the average bank acquisition model included a 7.2% organic growth rate in commission income. This helped banks exceed their return-on-investment goals and provides evidence that insurance brokerages acquisitions have been good investments.

Prompted by the termination of pooling-of-interest accounting and the necessity to incorporate insurance premium rate changes into the deal, banks now structure

**FIGURE 2**

Acquisitions Per Year - By Buyer Segment 1999 through 2003



Source: SNL Financial

agency transactions with a blend of up-front and earnout consideration. In 2003, banks adequately protected their base return thresholds by limiting guaranteed consideration at closing to an average of 86% of the estimated value. The balance of 14% was paid in the three to five years following the closing as an earnout (paid on performance in

## EVALUATING THE BANK'S INSURANCE PROGRAM

1. As a core component to the acquisition process, is there a formalized integration strategy that will enable the insurance operation to drive profit margins sufficient to yield a return to shareholders and to invest in a best-of-breed organic growth engine?

2. Has the bank committed to designing, installing, managing, and monitoring a commodity insurance distribution process that will ensure success in expanding wallet share per customer by selling insurance to the bank's core customer base?

3. Is there a formalized acquisition strategy designed to provide an insurance solution to bank customers within the footprint of the bank, expand bank market penetration to policyholders

that are not customers of the bank, and drive banking expansion beyond the existing footprint?

4. Are the financial metrics of the existing insurance operation measured quarterly against peer group benchmarks on a regional profit-center basis? Are performance comparisons a core component of the decision-making process of the insurance operation and are they communicated to the board?

5. How does the post-closing financial performance of acquired agencies compare to expectations that were established at closing? What are the differences between performance and expectations? What are the reasons for the differences and can strengths be leveraged and weaknesses minimized?

6. Does the bank have a formalized sales management program? If so, on a monthly basis are ratios such as appointment to quote, quote to close, and new business production per producer benchmarked relative to a peer group of comparably experienced producers?

7. Does the bank have an internal champion supporting the insurance strategy? Do the champion and the agency leadership have a network of peers with whom to exchange best practices ideas in order to create solutions to bank insurance challenges?

8. Do the bank and agency meet on a quarterly basis to develop, monitor, and modify an all-encompassing business plan?

excess of thresholds set in the closing acquisition model). The price paid for the average bank foundation agency in 2003, including “most likely” earnout consideration, totaled 7.95 times EBITDA (earnings before interest, taxes, depreci-

**FIGURE 3**

**Leading Banks with Insurance Brokerage Revenue**

<b>Bank</b>	<b>2003 Revenue (000s)</b>
1) Wells Fargo & Co.	800,500
2) BB&T	604,700
3) Wachovia	188,700
4) Greater Bay Bancorp	119,900
5) Commerce Bancorp. Inc.	82,400
6) Citizens Financial Group	80,700
7) FleetBoston Financial Corp.	70,300
8) UnionBancCal Corp.	60,100
9) First Tennessee National Corp.	58,400
10) Regions Financial Corp.	57,400
11) Compass Bancshares	52,800
12) Guaranty Bancshares	50,100
13) BankNorth Group	46,900
14) Sky Financial Group (1)	42,700
15) BancorpSouth Inc.	39,800
16) Old National Bancorp (1)	39,200
17) FNB Corp. (1)	35,300
18) Hibernia Corp.	33,700
19) Popular (1)	30,000
20) Cullen/Frost Bankers Inc. (1)	28,800
21) Peoples Mutual Holdings	25,800
22) Associated Banc-Corp	23,900
23) Trustmark Corp.	19,400
24) M&T Bank Corp.	18,400
<b>2003 Average Growth in Revenue</b>	<b>33.9%</b>

Sources: Business Insurance; SNL Financial (1)

ation, and amortization). While searching for additional foundation agencies to fill out the bank’s footprint, fewer acquisitions were closed and rolled into existing operations. Subsequent agency deals in 2003 were at guaranteed market values that were comparable to the market (5.36 versus 5.43) and total EBITDA multiples that were less than the market (6.69 versus 7.04).

Given the disparity in pricing by banks on foundation acquisitions relative to public brokers, many observers have questioned whether premium pricing has produced premium results. The answer is yes. Banks have paid handsomely for acquired agencies but, in exchange, they received strong organic growth of 11.5% and solid core profitability (as measured by EBITDA) of 25.1% (see Figure 5). In addition, foundation agencies have contributed a management team capable of pursuing, closing, and integrating additional acquisitions that drove overall revenue growth in excess of 30%.

The banks that acquired agencies during the 1990s set unrealistic cash ROI expectations of 15%, based on an expectation of a dramatic earnings lift from cross-selling insurance to bank customers. Banks now generally exclude potential cross-sell earnings and set more realistic return expectations. According to our deal experience, the average bank now requires a five-year average cash ROI of about 10.5% (achieving 13.2% by year five), accretion to cash EPS immediately, and accretion in GAAP EPS in year two, at the latest. Of the closed acquisitions we have reviewed in the past three years, we estimate that 88% of bank foundation agency acquisitions outperformed their deal-to-date financial targets. Solid productivity and strong core profitability accompanied strong organic growth and acquired growth as evidenced by actual EBITDA as a percentage of revenue of 25.1%. Thus, we believe insurance acquisitions by banks have been a good investment of capital.

**Cross-selling success**

While most banks have had financial success in the acquisition area, all are struggling with cross-selling insurance to bank customers, which was a core motivator in the decision to pursue an insurance acquisition strategy. Acquired agencies have improved their processes and are now achieving moderate success with medium-to-large commercial bank customers. Those few bank-owned agencies achieving success in this area recognized early on that the answer was not to force lenders to drive referral activity. A good bank customer is not necessarily a good insurance customer. Just as banks are in the business of managing credit repayment risk, insurance distributors are in the business of managing claims risk. This mismatch typically creates lender referrals that are plagued with a poor claims history or require insurance solutions that an acquired agency cannot solve or cannot afford to solve. The most successful bank-owned agencies have gained momentum by cross-referencing the specialty niche areas of the insurance operation with the bank customer base and taking a rifle shot at bank customers for which the agency is capable of providing a unique insurance solution.

**FIGURE 4****2003 Growth Rates by Segment**

<b>Total Comm/ Fees Growth</b>	<b>Public Brokers (1)</b>	<b>Bank-Owned Agencies (2)</b>	<b>Large Independent Agencies (3)</b>
Total Growth	20.0%	35.1%	14.6%
Organic Growth	9.0%	11.5%	12.7%

(1) Source: KBW article

(2) Source: Organic growth from MarshBerry Bank Agency Network (BANK)

(3) Source: MarshBerry independent insurance agency clientele

The frustrating part for most banks that have acquired foundation agencies is that there has been no success in enhancing wallet share. This is because there has been no success in cross-selling insurance to the core customer base of the bank, which principally represents consumers and smaller commercial borrowers and depositors. In the average bank, hundreds of thousands of bank transactions

**FIGURE 5****2003 EBITDA and Productivity**

	<b>Public Brokers (1)</b>	<b>Bank-Owned Agencies (2)</b>	<b>Large Independent Agencies (3)</b>
EBITDA as % Revenue	28.1%	25.1%	23.4%
Commissions Fees/Employee	156,278	146,607	138,795

(1) Source: MarshBerry (Actual EBITDA + MB estimated average overhead allocation), company reports

(2) Source: MarshBerry Bank Agency Network (after eliminating actual overhead allocation)

(3) Source: MarshBerry clientele

occur that require proof of insurance to collateralize credit to protect repayment risk. This information is captured by the bank at the loan closing, yet consumers are buying insurance every day from providers other than the bank-owned agency. Bank CEOs have threatened pain and penalty, yet there has been virtually no forward movement on providing an insurance solution to the vast majority of the core customer base.

The challenge stems from the cultural differences between insurance brokers and banks and the reliance of the bank on the agency to design a commodity-based insurance solution. High-quality foundation agencies do not know the first thing about commodity product distribution. Bank-owned agencies are typically large-account focused and are well suited for technical, relationship-based problem solving in areas such as complex risk assessment, risk management, loss control, and claims analysis. The majority of smaller accounts at acquired agencies have resulted from inbound calls or as an accommodation to

**John M. Wepler**

is executive vice president, **Tom Linn** is senior vice president, and **Patrick T. Linnert** is a consultant with MarshBerry, a Concord, Ohio-based national management consulting and acquisition advisory firm dedicated exclusively to the insurance distribution system.

high-net-worth entrepreneurial commercial business owners. The infrastructure, technology utilization, and workflow processes of most acquired agencies have not been built to cater to a large number of small accounts.

Acquired agencies do not normally have the capability or the capacity to immediately embrace commodity product distribution. The best insurance agencies in the industry have a rack of sophisticated, value-added services that 90% of the bank's customer base does not want or need, nor are they willing to pay to use. The sale of insurance to the average bank customer is not a relationship sale; it is a transactional sale where the customer wants conversion fast, now, and at a favorable price. Given the low average revenue per customer in this area, converting these customers profitably requires an extraordinarily efficient, technology-driven delivery channel that produces a sizable volume of referrals that can be converted predictably and with high closing ratios.

Boards should understand that the acquisition of an insurance broker does not automatically translate into an integrated insurance program that will meet the needs of the bank's core customer base. Successfully cross-selling insurance to the core customer base of the bank is the next frontier of banks in insurance. It is no longer a question of if the riddle will be solved; it is a question of when and how. Unlike many banking products, insurance is a permanent need of the customer base that transcends the expiration of a loan. The solution must be built, not bought. To build the right solution, the process must start with the bank. The insurance needs and purchasing practices of the retail and commercial customer base must be adequately assessed so that a delivery channel can be built that aligns customer needs with the products, services, sales, and delivery practices of the insurance operation. Banks truly committed to the business are in the process of executing a plan to aggressively design, build, install, and manage a comprehensive program that integrates the financial institution's insurance capabilities with its core banking functions.

**The big picture**

Banks have made great strides in entering the insurance distribution system since the passage of GLB. Foundation agencies have been acquired, subsequent agencies are being aggressively pursued and closed to leverage returns and enhance market share, interest rate risk has been mitigated by growing noninterest income, and investment returns have been overwhelmingly satisfied. Financial performance will be leveraged in the future as banks succeed in their design, installation, and management of an insurance delivery channel that meets the insurance needs of the core bank customer base. **|BD|**