

# The Growing Dominance of Banks within the Insurance Brokerage Marketplace

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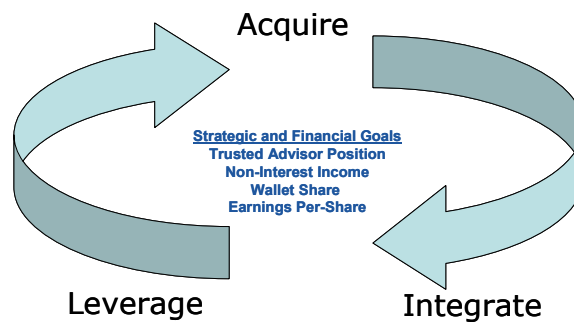
Since the passage of Gramm-Leach-Bliley, banks have become a dominant and permanent fixture in the insurance brokerage marketplace. The journey has been arduous for most banks, given failed and retooled cross-selling initiatives, slower than anticipated integration and the time required to bridge cultural hurdles. Despite the battle scars, banks should be proud. Bank owned insurance agencies have managed through innumerable issues with passion, conviction and creativity and today post the most impressive metrics of any insurance brokerage segment. This column will review the path successful banks have followed, financial success achieved by bank owned agencies and expectations for the road ahead.

## Strategy

Most of the bank owned agencies that are today achieving strong financial results entered the insurance arena with very specific strategic and financial goals. Insurance was initially attractive to banks as it complemented a strategic goal of enhancing the bank's position as a trusted advisor. High performing insurance agencies that embody a high touch, solutions oriented, management consulting culture tend to have close relationships within the middle and large commercial market. As a result, banks that acquired a high performing agency met the strategic goal of elevating the professionalism and trusted advisor status of the bank in the eyes of the corporate marketplace. From a financial perspective, banks entered the market with quantifiable goals in three areas, expansion of non-interest income, wallet share per customer and earnings per share.

Expansion of non interest income is a core strategy as banks strive to diversify net interest rate margin risk. Expansion of wallet share per customer is a focus as ample evidence supports 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 is the ultimate goal. In most banks, targets for expanding non-interest income and earnings per share have been surpassed.

Expansion of wallet share has fallen short of targets. In the middle market and large commercial area, banks underestimated the time required for bankers and insurance professionals to build trust and in turn, qualified referral relationships. In the area of retail banking and micro commercial, there has been almost no success integrating the insurance operation with the customer base of the bank. Acquired agencies typically do not have the capability or the capacity to immediately embrace commodity product distribution. Banks leading the charge have centralized the personal lines and small commercial units of acquired foundation agencies in order to create a department with sufficient volume to fund the development of an efficient sales, marketing and management system custom tailored for the bank's commodity oriented customer base. Despite a slow start, cross-selling performance has improved measurably and today, high performing agencies are generating as much as 50% of new business production from bank referrals.



### **Execution of Strategy**

While most banks evaluated alternatives for entering the insurance brokerage business (acquire, build or joint venture), banks achieving the best results entered the insurance brokerage business by executing a multi-faceted acquisition strategy. The first step for most banks was to select one major market territory within the bank footprint and acquire a foundation agency, defined as the highest quality agency in that territory that had the talent and financial performance to serve as the bank's insurance platform in that region. Most banks are only midway through the execution plan, which calls for a foundation acquisition in each major bank territory until the footprint is covered with an insurance presence. Integration of the insurance operation into the bank organization is continuous and is a critical component to leveraging the bank-insurance platform. The acquire, integrate and leverage lifecycle will continue to evolve in order to ensure that long-term strategic and financial goals are attained.

### **Acquire**

Competition on agency deals with publicly traded insurance broker buyers has been fierce. Public brokers have no choice but to acquire, given low organic growth. The inability to grow organically has forced public brokers to disclose their current deal pipeline and expected annual acquisition growth to justify market growth expectations, which only serves to feed the need for more deals. Despite competition, banks have fared well against the brokers, closing almost 31% of the transactions that occurred between 1/1/00 and 08/30/05:

| <b><u>Acquirer Type</u></b> | <b><u>Total Acquisitions</u></b> | <b><u>% Total</u></b> |
|-----------------------------|----------------------------------|-----------------------|
| <b>Bank or Thrift</b>       | <b>436</b>                       | <b>30.4%</b>          |
| <b>Public Broker</b>        | <b>342</b>                       | <b>23.9%</b>          |
| <b>Independent Agency</b>   | <b>297</b>                       | <b>20.7%</b>          |
| <b>Insurance Company</b>    | <b>252</b>                       | <b>17.6%</b>          |
| <b>Other</b>                | <b>106</b>                       | <b>7.4%</b>           |
| <b>TOTAL</b>                | <b>1,433</b>                     | <b>100%</b>           |

Source: SNL Financial

Foundation agencies tend to be large in size, relative to the other agencies within a territory. As a result, the 436 closed transactions have

enabled banks to amass considerable insurance revenue. During 2004, P&C and group health insurance brokerage revenue within the 30 largest bank owned agencies totaled \$3.5 billion, up from less than \$400 million during 1999. Excluding the two largest public brokers Marsh & McLennan and AON, banks represent 13 of the 40 largest insurance brokers and 24 of the top 100 insurance brokers.

Also consider the fact that participants attending the fall 2005 **Bank Agency Network (BANK)** meeting in Phoenix (averaging \$32 million in insurance brokerage revenue) plan on acquiring over \$330 million in additional brokerage business over the next twenty-four months.

Banks structure agency acquisition transactions with a blend of guaranteed consideration and earn out consideration. During 2004, banks protected their base return thresholds by limiting guaranteed consideration at closing to an average of 89% of the estimated value. The balance of 11% will be paid to sellers during the next three to four years as earn out consideration, provided that performance exceeds thresholds set at closing. Including earn out consideration, pricing metrics remain strong for peak performing agencies with brokers paying about 7.25 times EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization), banks paying around 8.0 times for foundation agencies and banks paying 6.8 times for subsequent in-market transactions. Pricing in general is up slightly over 2003 figures for high quality targets as public brokers and banks scrap over the dwindling pool.

### **Integrate**

Integrating acquired agencies has followed a slower path than originally anticipated. Earn outs have provided banks with downside protection and have successfully secured return hurdles. But, these performance based payments have motivated sellers to focus on their core business versus working aggressively on integration. Integration has also been delayed as banks have provided sellers with autonomy to allow both sides to become comfortable with the divergent cultures to minimize the level of disruption on the staff of acquired agencies. Despite the slow start, integration activities are taking hold and banks are making progress.

In the area of automation, 70% of the bank owned agencies at the most recent BANK meeting have converted all of the foundation agencies to one automation system. In regards to developing systems that support wallet share, while only 55% of the bank agency group have an electronic referral form and an automated insurance referral database in place, most of the remaining banks have plans to roll out a system within the next two years. In the area of sales management, only 42% have centralized sales management governing consistency in producer compensation, new business production and prospecting activity. However, over 75% report that such a management discipline will be in place by 2007 and almost all noted that they will have a defined minimum standard of performance for producers to retain their status by that time. Ninety percent have a dedicated CEO of Insurance with no banking responsibilities and another 90% have centralized the human resource function. On average, the number of centralized full-time equivalent corporate employees totaled 5.4, or one per \$10,000,000 of revenue. Bank owned agencies are focused on centralizing corporate functions over the next three to five years with the aim of eventually building a corporate department that governs the executive management of the insurance subsidiary.

High performing bank owned agencies have also made progress in the area of workflow and procedures in order to drive low E&O claims and high customer retention. Twenty-nine percent of the bank owned agencies in the group require that producers complete a service timeline for each middle market and large commercial account. High performers are requiring that service commitments are set up as activities within the agency management system in order to tie individuals within the service team to commitments made to the customer. Such commitments are reviewed via quarterly workflow audits where exception reports are generated from the agency management system that identify where activities have not been completed as promised. This information is incorporated as part of the review process for the members of the service staff, including compensation adjustments and bonus incentives.

## Leading Banks with Significant Insurance Brokerage Revenue

| Bank                           | 2004 Rank | 2004 Broker Income in Millions |
|--------------------------------|-----------|--------------------------------|
| Wells Fargo & Co.              | 1         | \$944                          |
| BB&T                           | 2         | 680                            |
| Wachovia Corp.                 | 3         | 411                            |
| Bank of America Corp.          | 4         | 206                            |
| Greater Bay Bancorp            | 5         | 133                            |
| Citizens Financial Group, Inc. | 6         | 86                             |
| Commerce Bancorp. Inc.         | 7         | 86                             |
| FleetBoston Financial Corp.    | 8         | 75                             |
| UnionBanCal Corporation        | 9         | 68                             |
| Regions Financial Corp.        | 10        | 67                             |
| First Horizon National         | 11        | 60                             |
| Compass Bancshares             | 12        | 59                             |
| Guaranty Bancshares, Inc.      | 13        | 59                             |
| BancorpSouth Inc.              | 14        | 58                             |
| BankNorth Group Inc.           | 15        | 52                             |
| Old National Bancorp           | 16        | 51                             |
| Sky Financial Group, Inc.      | 17        | 49                             |
| Associated Banc-Corp           | 18        | 43                             |
| Webster Insurance Inc          | 19        | 42                             |
| Popular Inc.                   | 20        | 39                             |
| Hibernia Corp.                 | 21        | 35                             |
| Cullen/Frost Bankers Inc.      | 22        | 31                             |
| Eastern Insurance Group LLC    | 23        | 30                             |
| Peoples Mutual Holdings        | 24        | 26                             |
| ABN Amro                       | 25        | 23                             |
| Trustmark Corp.                | 26        | 19                             |
| M&T Bank Corporation           | 27        | 18                             |
| BNCcorp, Inc.                  | 28        | 17                             |
| Bank of Hawaii Corp.           | 29        | 16                             |
| First National of Neb.         | 30        | 15                             |
|                                |           | <b>\$3,498</b>                 |

Sources: *Business Insurance*, *Bank Insurance Market Research Group*, *SNL Financial and Company Reports*

### Leverage

Given the premium paid by banks on foundation acquisitions relative to public brokers, many question whether premium pricing has produced premium results. The answer is yes. Banks have paid handsomely for acquired agencies, but in exchange received strong organic growth and solid core profitability (as measured by EBITDA). In addition, foundation agencies have contributed a management team capable of pursuing, closing and integrating additional acquisitions that has produced revenue growth in excess of any other segment. Banks have been careful, astute and aggressive buyers of insurance distributors and momentum will continue as financial results continue to support acquisition activity.

### YTD 6-30-05 Growth Rates by Segment

|                               | Public Brokers (1) | Bank-Owned (2)<br>Agencies | Large Independent<br>Agencies (3) |
|-------------------------------|--------------------|----------------------------|-----------------------------------|
| <i>Total Comm/Fees Growth</i> |                    |                            |                                   |
| Total Growth                  | 14.5%              | 13.0%                      | 9.2%                              |
| Organic Growth                | -1.1%              | 9.7%                       | 8.5%                              |
|                               | 0.7%*              |                            |                                   |

(1) Source: Select Public Broker Information, MarshBerry

\* Excluding Marsh

(2) Source: Public Information, MarshBerry Bank Agency Network (BANK)

(3) Source: MarshBerry Independent Insurance Agency Clientele

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 at the latest during year two. Of the closed acquisitions we have reviewed during the past three years, we estimate that 88% percent of our client's initial (or first) agency acquisition outperformed their deal-to-date financial targets. Additionally, 71% of BANK partners noted that acquired agencies in general have attained the expected base level of profitability post-closing. In short, insurance acquisitions by banks have been a good investment of capital. Solid productivity and strong core profitability accompanied strong organic growth. The profitability of public brokers has led the market, despite lower growth, as public brokers are masters at leveraging margins post-closing, given decades of experience in insurance acquisition deal integration.

The Property & Casualty insurance market is presently in a soft market. To be specific, the industry has absorbed a hit to aggregate P&C premium rate increases, from 14.8% during 2002 to 9.3% during 2003 to 4.5% during 2004. Some estimate that P&C premium rate increases will drive only a 1.2% increase during 2005, which may even be aggressive given declining P&C rates during the summer of 2005. Despite estimated aggregate insured hurricane losses of up to \$70B during 2005, the reinsurance market and underwriters are well positioned to service losses. Combining these

strong balance sheets with a rising interest rate environment means that the P&C market should not expect a hardening of rates over the next twelve months, but a leveling of rates at best.

While harder rates during 2001 and 2002 helped buoy past performance,

bank owned agencies appear to be better prepared for the current and projected soft market conditions given strong organic growth. Overall, high performing bank owned agencies have prepared for this market cycle by creating a predictable organic growth culture supported by accountability, discipline and a process to proactively over serve the customer. This is evidenced by strong historical and current organic growth rates. Through the first half of 2005, leading bank-owned insurance platforms achieved 9.7% organic growth versus average public broker growth of -1.1%. Bank-insurance performance will only improve over time as cross-selling initiatives continue to gain traction.

#### The Road Ahead

Bank owned agencies have made considerable progress entering the insurance brokerage industry. Banks have captured the flag in acquisition activity and organic growth. In addition, most acquired agencies have outperformed earnings targets despite the fact that integration has only started to materialize. During the coming decade, banks will continue to acquire, integrate and leverage acquired agencies until the insurance platform mirrors the geographic footprint of the bank and an insurance solution is available to every bank customer. Banks have become a permanent, dominant fixture in the insurance brokerage marketplace. This movement will only gain momentum as banks continue to leverage insurance to expand non-interest income, wallet share per customer and earnings per share.

