

Are Banks Going to Eat Your Lunch?

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I've been a banker, a Wall Street banking analyst, and now a strategy consultant in banking and financial services for a total of 27 years. If I've learned anything in that time, it's "never say never." Any industry in which a Travelers can merge with a Citicorp will undoubtedly continue to produce more than its share of surprises.

That said, the question I've been asked to address is "Are banks going to eat your lunch?" which in turn leads to a second question, "Will banks eat you," through mergers or acquisitions. With some possible exceptions which I'll get to shortly, to me the most probable answers are "no" and "no." In fact, I believe that some banks may potentially be among your most profitable customers.

Core Competencies

Banks and reinsurance companies share certain areas of expertise, notably investment management and capital markets. However, as reinsurers, your unique core competence centers around property and casualty underwriting. At least as well as anyone, you know how to evaluate, price and reserve for the risks of the perils you cover. With the exception of Citigroup, a unique company with a unique history, there isn't a bank in the United States that would dare to make a similar claim.

Rather, the core competence of banking is credit, as applied to individual borrowers and counterparties as well as to the management of portfolios consisting primarily of unrated credits, most of which are well below investment grade or they wouldn't be borrowing from banks in the first place. As I reported for Brown Brothers Harriman about three years ago, credit quality, or its absence, accounts for about 75% of the earnings of large U.S. commercial banks.

Credit Derivatives

As you well know, the world of credit *derivatives* has been growing rapidly, especially among the large banks, global investment bankers and insurance companies which have the expertise and balance sheet strength to deal in them. At their best, credit derivatives and similar financial instruments provide users with attractive opportunities to hedge many of the risks in their portfolios. However, it seems to me that, in most cases, there is still likely to be considerable basis risk between the specific risks covered by a credit derivative and the particular situation of an insured. The evaluation and pricing of that basis risk requires precisely that property and casualty underwriting expertise which you possess and which banks generally do not.

At least at this point in time, the banks with whose strategies I am generally familiar would rather buy that expertise, by working with you, or let you buy their capabilities in derivative products, by working with them as dealers and counterparties, than go into competition with you as insurance underwriters. As the bankers say, they don't have to own the factory to sell the product.

Volatility of Earnings

Banks are, of course, highly leveraged. That's one reason why credit risk is so important to them, and this leverage also serves to increase the volatility of their earnings from all sources. This leverage and the resulting earnings volatility have serious consequences for two of the banks' most important constituencies: rating agencies and stockholders.

The cost of borrowed funds is a critical component of a bank's profitability, especially for those larger institutions which are active in the financial markets. This, in turn, is significantly influenced by credit ratings, and by the market's perception of what rating changes might occur in the future. Indeed, in extreme situations such as the latter part of 1998, market perceptions of credit quality – whether accurate or not -- have played key roles in determining some institutions' very survival.

It's no secret that rating agencies don't like volatile earnings. In fact, a stable income outlook is a stated prerequisite for the higher credit ratings of both Moody's and S&P. As a longtime equity analyst, I can tell you that most institutional stock investors don't like earnings volatility either. I recall one meeting I had a few years ago with a good brokerage client, a fund manager in Edinburgh. At the time, I felt that J.P. Morgan's stock was undervalued, and proceeded to tell him why. When I got through, he replied, "Ray, that's all well and good, but I can't buy a stock for which I can't predict the next quarter's earnings."

J.P. Morgan, of course, is primarily an investment bank, active in trading, risk management products, securities underwriting, private equity investing and advising on mergers and acquisitions. These have all been good businesses for them, especially in a bull market, but none is known for the predictability of its short-term results.

Property and casualty underwriting can also be a good business, for skilled practitioners and in the right part of the market cycle, but it, too, does not lend itself to readily predictable short-term results.

Indeed, as Warren Buffett has so frequently observed, it is Berkshire Hathaway's very willingness and ability to withstand volatile income and loss streams that enable it to be a profitable reinsurer in the long run. As he says, "I'd rather have a lumpy 15% return on invested capital than a smooth 12%."

Rating agencies and most institutional equity investors don't agree, however, and it is that, added to their lack of underwriting expertise, which I believe will keep most banks out of the business of underwriting property and casualty insurance, or at least out of the business of retaining most of the risk for their own account. U.S. banks are simply too highly leveraged, and too dependent upon the market's evaluation of their own risk situations, to have much choice about that.

As the controlling shareholder of so large a company, Mr. Buffett has the luxury of not having to worry about what institutional investors might think of his earnings stream, a position which any banker I know would greatly envy.

***Bancassurance* and Financial Supermarkets**

The future of so-called financial supermarkets, providing one-stop shopping for all of a customer's financial needs, has always been a rather controversial subject, on which I've generally been among the skeptics.

As you know, *bancassurance* has been tried in Europe for many years, and the results so far have been very much of a mixed bag. It seems to work best in countries such as France, Belgium and Spain, where the regulatory climate has been friendly toward it for a long time and where customers have grown used to buying insurance products from banks. Even there, the most successful products have been simple, personal lines which don't require much expertise to sell, to relatively unsophisticated customers whose needs are generally simple as well.

Two British cases are worthy of note, Direct Line and Lloyds TSB. Direct Line, owned by The Royal Bank of Scotland, has been a great success selling personal auto – sort of a British version of GEICO -- and now, homeowners and life policies over the phone and, more recently, on line.

However, there is very little overlap between Direct Line customers and those of the bank, for which Direct Line has been little more than a highly successful venture capital investment. As *bancassurance*, I don't think it proves much of anything.

In contrast, Lloyds TSB provides both good and bad examples from which we can learn. The old TSB, before merging with Lloyds Bank in 1996, was essentially a savings bank that served a relatively downmarket, blue-collar clientele. It, too, was successful in selling simple personal lines, in relatively small amounts, to customers with simple needs who were generally overlooked by the larger clearing banks and mainstream insurance companies, who tended to go after the more affluent middle class.

Lloyds Bank, on the other hand, had a relatively upscale customer base and during the 1980s bought a controlling interest in Abbey Life, a specialist in annuity policies that was at one time owned by ITT. It's not property and casualty insurance, but along with most of the UK life insurance industry, Lloyds Abbey Life was caught up in a large, ongoing controversy over government accusations of policy mis-selling that has so far cost it over GBP 800 million in loss provisions, pretty much wiping out whatever profits the life business earned. For Lloyds TSB, the only good news that has come out of this was that, as with Direct Line, only a very small percentage of its banking customers had relationships with Abbey Life, or else the damage to the bank's reputation could have been far greater. Lloyds TSB has since acted to wind down Abbey Life and has recently acquired Scottish Widows, a company with a very strong brand, for which it has had to pay a correspondingly high price. We'll see how that works out for them over time.

However mixed the experience of *bancassurance* has been, a few U.S. companies are likely to try it anyway. Even among the majority of U.S. banks which share my skepticism, the attraction of offering car insurance to those customers buying a car, for example, or homeowners insurance to those taking out a mortgage, has always been present and is only likely to grow in today's less restrictive regulatory environment.

Whether banks choose to offer property and casualty insurance as brokers or through their own underwriting units, the attractiveness of ceding risk to the reinsurance industry is undeniable, as it enables them to capture the benefits of the customer relationship while strictly controlling the risks which they take onto their income statements and balance sheets. That is why I believe that banks may be among your best customers in the years to come.

Take a Banker to Lunch

So, my advice to you is this: instead of worrying about whether banks will eat your lunch, take a banker *to* lunch. Get to know the banks' strategies, the economics of their business, what they really need and want to offer their customers, what risks they are and are not willing to assume for their own accounts. Then, you'll be able to structure proposals to work with them as strategic partners, to the benefit of both parties.

Banks, then, are unlikely to eat your lunch. They're not used to the food, and in all probability it would give them indigestion, much as some of the credit risks which they routinely take would probably bother you. Let me move on to the second part of the question, though: what about banks eating you?

Will a Bank Eat You?

At least potentially, that would solve one of the issues I raised, namely banks' lack of in-house underwriting expertise.

However, for a bank to buy a property and casualty underwriter would not resolve the problem of earnings volatility which we have just discussed, and would in fact layer another problem on top of it: the dilutive impact of the premium paid to the seller.

From a financial point of view, if a bank really wants to get into this business, it would seem to make little sense to pay a control premium to purchase a property and casualty underwriter. Rather, why not invest in one, as a minority, non-controlling shareholder, avoid the control premium and reduce the volatility of reported earnings as well? This was precisely the approach taken by J.P. Morgan with its investments in Centre Re, Exel and Ace, which as you know have worked out well for all concerned. Gramm/Leach/Bliley has somewhat expanded banks' flexibility to structure such investments in the future.

As I began my remarks, however, "never say never." The principal exceptions to the general unattractiveness of outright acquisitions and mergers of banks and property/casualty insurers, I believe, will be found among those banking companies which are already in the business, notably Citigroup and, to the extent that they are willing and able to take advantage of Gramm/Leach/Bliley, European-based universal banks. For reasons which are already well known to you, property/casualty underwriting is a business in which size matters -- in operating efficiency, in providing greater opportunities to diversify risk, in attracting better credit and counterparty ratings, etc., etc. I expect consolidation in this industry to continue, and players already owned by universal banking groups are likely to participate as well.

So, besides taking a banker to lunch, why not take your industry colleagues to lunch as well? Who knows what might develop, and if anything does, I see some very good merger lawyers here who might be willing to help out.

With the observation that lunch follows the end of this panel, let me stop here and allow our chairman to keep things moving.

Thank you very much.