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Comparing alternative structures of financial alliances

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Abstract: In this paper we study alliances between banks and insurance companies. Firstly, we characterize the driving forces behind financial alliances and networking trends. Then we give an overview of relevant previous research. We define six different structure models for financial alliances. The parameters of the models are the closeness of the alliance in terms of mutual ownership, and the question whether or not alliance partners have overlapping service channels. Examples of the models are given in the Finnish bank and insurance market.

Next, we characterize nine criteria according to which the previously defined models are to be compared to achieve the most attractive alliance model. Thus, we obtain a multi-criteria decision making (MCDM) problem. In the design of the criteria representatives of the top management of Finnish banks and insurance companies have been consulted. We conclude with some ideas for further research, especially to solve the present MCDM problem.

Keywords: *Financial alliances, financial convergence, financial conglomerates, multi-criteria decision making, strategic planning*

1 Introduction

Networking and alliance formation have been growing trends among the financial industry during the last decades. In many European countries it became almost an industrial practice in the late eighties to step over the borderline between banks and insurance companies. It was often a bank which had calculated that it would produce good synergies to start up an insurance subsidiary, or perhaps both a life and a nonlife subsidiary, and then sell their products via the bank's own distribution network. In the nineties big financial conglomerates which include both banks and insurance companies emerged both in USA and Europe.

Launching financial conglomerates was generally based on the same hypothesis as intra-sector mergers: centralized ownership helps to achieve and utilize the critical mass and, thus, increase efficiency. It was also believed that different business lines could diversify the business portfolio and equalize business cycles. There are many firm supporters of financial conglomerates but as we have entered the new millennium we have also heard their opponents' statements. The diversification potential has both in

theory and practice been questioned. The different attitude to risk in the banking and the insurance industries has worried some observers especially in the insurance sector. On the other hand, because of the obvious benefits of cross-selling some kind of alliance between banks and insurance companies should be desirable. Therefore, one can ask what is the most appropriate depth of an alliance given the financial institution's business objectives.

The term "financial alliance" occurs seldom in the literature - when authors refer to groupings which are looser than conglomerates they often use the term "financial convergenge" (see section 2). The scientific dialogue in this field is both scarce and rather pragmatic, and systematic approaches to selecting the best alliance model can hardly be found.

In the following we use the term, "financial alliance" to stand for an alliance between one or several banks and one or several insurance companies. The insurers in an alliance can be life and/or nonlife companies. Alliances between banks and nonlife insurance companies with no life counterparts are in practice rare. On the other hand, synergies between retail banking and life insurance are so significant that one often encounters alliances between banks and life insurers without nonlife counterparts.

Financial alliances often include units like mutual fund managing companies, asset management companies, securities brokerages and corporate finance companies, but for the sake of simplicity we restrict ourselves in this paper to the groups of banks and insurance companies. (In most European countries banks are allowed to be “universal”. Consequently, it is customary that they include the above mentioned functions. The same holds more and more often for insurance companies.)

The driving forces behind the alliance or networking trend are, for example:

- narrowing profit margins in banks and insurance companies call for new sources of income by cross-selling ;
- tight margins can also necessitate savings and cut-off programs which can be more effectively carried out by closer alliance structure ;
- changing customer behaviour such as one-stop shopping requires co-operation between all financial service providers ;
- international trade agreements are dismantling tariffs and breaking down barriers to trade allowing more companies to enter new markets (Ryan [2001]) ;
- Regulators are espousing greater competition because they are recognizing the economic benefits to their countries and their customers (Ryan [2001]) ;
- cross-selling can play, and has played an important role in preventing job losses and creating employment in the banking sector (Benoist [2002]).

The aspect in this paper is managerial. Another two possible aspects would be supervisory, although there are common factors in these

perspectives, and a customer's. We also concentrate on the retail market although alliance formation also has significance in relation to other customer segments.

2 Overview on previous research

Focarelli and Pozzolo [2001] point out that during the nineties the number and value of mergers and acquisitions increased rapidly in virtually all sectors of economic activity. They have been particularly frequent in the banking sector, thanks to widespread deregulation, which permitted the integration of financial activities such as banking, asset management, and insurance. Vander Vennet [2002] shows that financial conglomerates are more revenue efficient than their specialized competitors. His results indicate that the current trend toward further de-specialization may lead to a more efficient banking system.

Financial convergence. The emergence of alliances is connected to the financial convergence, which means blurring of conventional boundaries of once discrete financial sectors (Ryan [2001]). Converging sectors are assuming each other's tasks. A good example is the credit insurance which can be used as a credit security instead of a bank guarantee. Convergence is driven by a need for growth by entering new markets, and by the desire to maximize share of wallet from every customer (Ryan [2001]). Van den Berghe and Verweire [2001] point out that one or another form of the financial convergence can be witnessed in many, if not all, developed markets. Much attention has been given to the convergence in the retail market, but there is a growing convergence trend in the US financial markets involving commercial insurance companies, reinsurance companies and leading investment banks.

Supervisory perspective. We comment on research concerning supervisory aspects of convergence only very briefly here. Convergence has brought about somewhat similar solvency regulation for the banking and insurance sectors. Bittermann [2003] compares banking and insurance risks and points out that in Germany, for example, the convergence of the financial sectors has resulted in merging the respective supervisory authorities. On the other hand, Manghetti [2002] comes to the conclusion that supervising even multinational financial conglomerates does not necessitate the convergence of supervisory authorities. OECD [1998] gives three alternative approaches of regulatory requirement and capital adequacy of converged financial institutions. Also Van der Berghe and Verweire [2001] discuss implications of financial convergence for supervision and regulation. Verweire [1999] shows that the risk profile of financial conglomerates is better than that of specialized suppliers (specialized banks and specialized insurance companies).

Shareholder aspects. Cybo-Ottone and Murgia [2000] study whether European cross-product mergers have created positive shareholder value. They document positive results driven by the strong market reaction of

deals announced between banks and insurance companies. Those mergers show very high cumulative abnormal returns. Cybo-Ottone and Murgia explain this by economies of scope or revenue efficiencies due to cross-selling of bank and insurance products to retail customers. In USA, The Citicorp-Travelers Group merger in 1998 increased the prospects for new legislation to remove the barriers between banking and insurance, resulting in a positive wealth effect for institutions most likely to gain from deregulation. Carow [2001] proves that at the time of the merger investors expected large banks and insurance companies to receive significant benefits from congressional legislation removing barriers to bancassurance (consolidation). Later on the new Citygroup has been expected to divest its non-core business areas.

Diversification. Boyd et al. [1993] used hypothetical cross-product mergers and simulations and found risk reduction effects from these deals. Boyd and Graham [1988] found that life insurance companies seem to offer good prospects as matches for bank-holding companies because of potential diversification gains. See also Lown et al. [2000] and Ladermann [1999].

Estrella [2001] examines direct measures of potential diversification gains from consolidation of financial firms. His results indicate that there may be bilateral diversification gains from mergers involving the banking and insurance industries. Estrella points out that these gains are not limited to life insurance as suggested by the previous authors, but extend to nonlife insurance companies, which actually lead to larger diversification gains than with life insurance companies. He also shows that life insurance and nonlife insurance have relatively large correlations with regard to each other, but also with regard to large banks. One of the main reasons that banking-insurance combinations enhance diversification is not lack of commonality, but that the insurance industries are already highly diversified compared to other financial sectors.

The emergence of alliances has also influenced finance product sales: according to SIGMA [2003], growing sales of life insurance in banks has increased, especially unit-linked sales volumes.

3 Structure models for financial alliances

As we described in section 2, the existing literature on financial alliances is strongly concentrated around alliances created by cross-sector ownership. The objective of this work is to find out if ownership really is superior to looser alliance models.

Alliance structures can be classified in three categories according to the degree of closeness of the members. The categories in the increasing order of closeness are

- Cross-selling agreements. The parties agree to sell each other's products to their own customers. (One can alternatively cross-sell by

selling one's own products to the other party's customers. This can be recommended if the products are complicated. This type of cross-selling is often made more effective so that one party gives with the customer's permission his/her contact information to the other party for marketing their products.) The cross-selling is frequently one-sided. Then most often a bank sells an insurance company's products to its customers. Life insurance products, especially, depending on the tax system, can bring immediate added value to a retail bank's customer service process and they can be sold effectively by the bank sales force (cf. for example Van den Berghe and Verweire [2001], Benoist [2002]). Similar advantages for insurance companies are not so obvious. Generale and Gobbi [1999] show that the most efficient banks in developed countries earn a smaller percentage of their profits from traditional activities and a larger share from off-balance-sheet operations (like life insurance and mutual fund sales).

This alliance category can still be divided to two subcategories depending on whether the parties' service channels are overlapping or not. Here a service channel can be a branch office network, but also a call center or website etc. Especially in the case of overlapping branch networks one easily faces channel conflict: the alliance members do not co-operate effectively, due to the fear of losing their customers to the other party and consequently such items as sales provisions. Non-overlapping service channels often means that the other party has no service channel at all - it functions as a product provider and uses its associates' sales force(s) to reach its customers.

- Alliance of independent partners. This alliance type is a special case of a cross-selling agreement where the alliance is tightened by cross-ownership and/or joint ownership in third parties**.** Cross-ownership means a minority stake of the other party's shares. If the ownership were one-sided, it would probably be a sign of asymmetry and one party's dominance of the alliance. An example of joint ownership is a mutual fund management company owned jointly by a bank, or banks, and an insurance company, or insurance companies. One could also think about cross-ownership/joint ownership without a cross-selling agreement, but such a model seldom occurs in practice.

- Control by ownership. A weakness in both the previous models is that it can be difficult to satisfy each alliance member with respect to the division of earnings and costs. This can be avoided by concentrating all the control in one of the alliance members. (This is called "bancassurance" if a bank has taken control. The opposite model "assurfinance" is not considered to be so effective. Van den Berghe and Verweire [2001] claim that the only succesful route in this respect is buying an existing bank instead of establishing one from scratch. Benoist [2002] comments assurfinance in further detail.) There are two ways of implementing control by ownership**:** a bank can simply own (a control of) an insurance company or vice versa. In a more sophisticated ownership model a holding company owns a number of banks and insurance companies. It is for this structure that we use the

term "financial conglomerate". This is a result of a cross-segment consolidation. Recently consolidation has also been happening across countries ("cross-geography consolidation").

An example of a financial conglomerate which offers its customers a large portfolio of financial services is Citigroup (Carow [2001], Ryan [2001]). Some firms, like ING, have chosen to specialize in just a few select services (Ryan [2001], Kist [2001]). Kist [2001] points out that the premise for creating such conglomerates is to create value for all stakeholders, i.e. shareholders, employees, and, most important, their clients. He also defines an integrated financial services company (IFS) as an organization that provides insurance, banking, and asset management products to its customers through a variety of distribution channels. IFS can be understood as a well-integrated financial conglomerate. It has the unique ability to develop tailor-made banking, insurance, and asset management products for its customer base (Kist [2001]). Being a conglomerate increases the number of opportunities to diversify. For instance, it enables greater geographic diversification. For example, the Nordic Swedbank, Nordea and Sampo have successfully established themselves in the states around the Baltic Sea.

There is quite scarce and only recent literature available concerning alliance models. The division of the models mentioned by Van der Berghe and Verweire [2001] is otherwise similar to ours but they do not differentiate between overlapping and non-overlapping service channels. The model classification by Benoist [2002] is somewhat different including for example franchise agreements and joint ventures which have not been used in the Nordic countries.

In Finland there are examples of most of the presented alliance categories: The Okobank group, Fennia Insurance group, and the Local Insurance group have a cross-selling agreement with overlapping service channels; GE Financial Insurance has a one-sided sales agreement with several financial institutions with no overlapping service channels; the nonlife insurer Pohjola, the life insurer Suomi, and 32 local savings banks have an alliance of independent partners with overlapping service channels and with joint ownership in a mutual fund management company and a retail bank; control by ownership has been adopted by banks like OP Group, Handelsbanken and Aktia by establishing or acquiring a life insurance company, and by Tapiola Insurance group by establishing a bank; and finally, Sampo Group is an example of a financial conglomerate. See also figure 1. Because there are so many models in real use in Finland, the problem of selecting the most attractive model is most relevant.

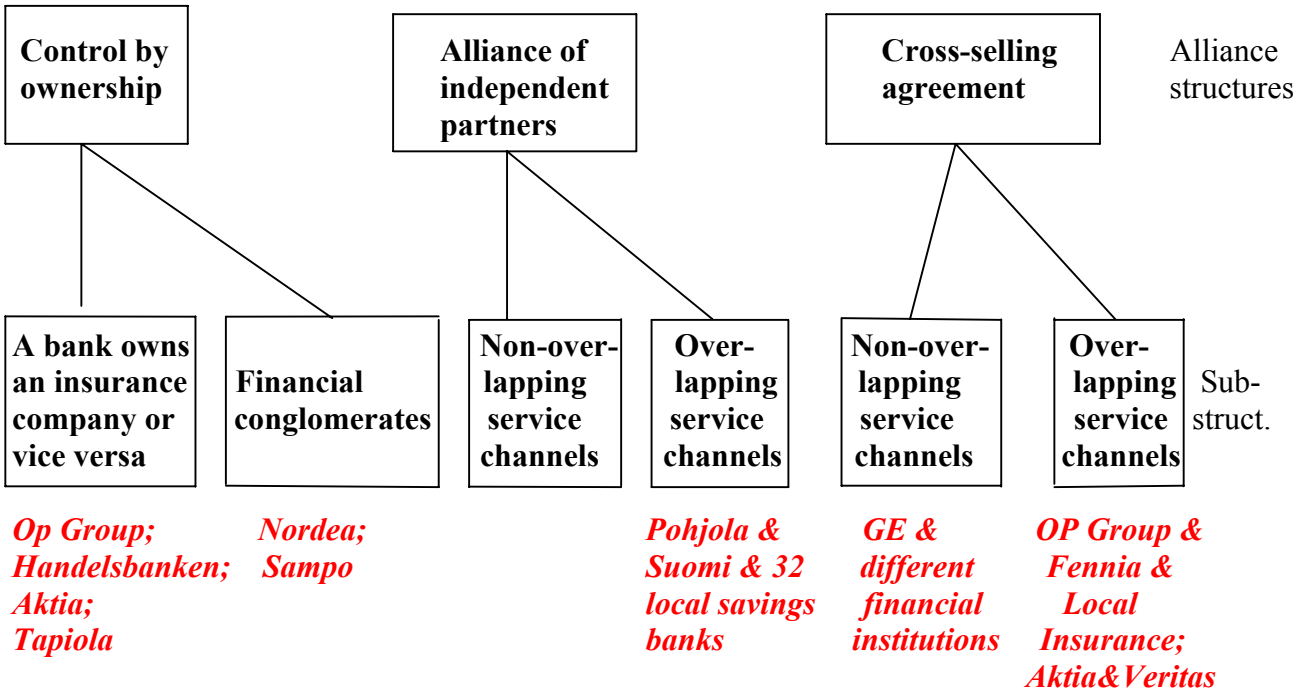

Figure 1. Examples of structure models adopted in Finland.

4 Criteria for model comparison

The alliance models described in section 3 shall be compared and eventually prioritized according to the following criteria. The decision maker here is the top management of a financial enterprise which is considering various ways to create a financial alliance. Another possible and interesting point of view would be that of a supervisory authority, but we do not discuss it here.

The criteria are here understood as objectives which should be optimized. They are not necessarily quantitative. The criteria we suggest here are to

1. maximize the efficiency of product development, especially the design of combination (hybrid) products,
2. implement the one-door-principle as effectively as possible,
3. compromise possibly conflicting earnings logics as well as possible
4. maximize the efficiency of customer relationship management
5. optimize cost and revenue synergies
6. minimize channel conflicts
7. optimize required solvency capital
8. maximize investor power
9. maximize the efficiency of sales management

Let us take a closer look at these criteria.

1. *"Maximize the efficiency of product development".*
Quality of product development is essential for any financial institution, and it is useful to be able to control it through co-operating partners. Combination products as, for example, a loan and a loan protection insurance, or a mortgage loan connected to a mutual fund savings plan, are a way of packaging different offerings together and deepening the customer relation. Van der Berghe and Verweire [2001] give an interesting view of the future of integrated financial services. They point out that one does *not* need an integrated group of financial suppliers to offer integrated products. If distribution will be able to offer client-oriented financial services from different financial services providers, they might evolve to become important players in the financial sector.

Decreasing active age groups and growing old age groups cause a serious financing problem for entire national economies. Nguyen [2003] examines the optimal pension model and its influence on individual saving behaviour, especially under the influence of an ageing population. Demange and Laroque [2001] study the functioning of social security schemes under demographic shocks. On the micro level, we shall probably witness creation of more long-term savings products with tax incentives with which individuals can complement mandatory social security systems. This again calls for the successful combination of various financial products. Benoist [2002] points out that in U.K. and Germany the creation of stakeholder pensions has increased the potential benefits of mergers and alliances between bankers and insurers. Ryan [2001] anticipates new markets for individual pension products and, more generally, products that provide financial security in old age.

2. *"Implement the one-door-principle as effectively as possible"*.
One-door-principle means that a customer is offered as many bank and insurance products as possible at one place during one customer service event. The objective is full customer service at one stop and, thus, again packaging different products together and deepening customer relation. Benoist [2002] concludes that this makes life easier for clients. Van der Berghe and Verweire [2001] discuss one-door-principle and conclude that it suits some customers, while others prefer shopping around themselves.

3. *"Compromise possibly conflicting earnings logics as well as possible"*.
In an alliance partners have to fit together their earnings logics. From one alliance member's point of view control over the other members obviously helps to optimize the result.

4. *"Maximize the efficiency of customer relationship management".*
Customer-orientation means for example selecting his/her needs as a basis for business generation, and tailoring the service according to the business volume generated by the customer. The customer is given a responsible contact person and uniform service through the organization is secured by sufficient internal training. Customer orientation must also show in provision structures: the customer does not nowadays accept being

forgotten after the sales transaction, and provision structure must reward the salesperson for the long-term care of the customer. According to Ryan [2001], most Americans maintain relationships with several different financial services providers but recent surveys show that over 50 per cent of consumers want to consolidate their financial relationships. The change in insurance customers' behaviour and expectations is discussed for example by European Commission [1996], p. 5.

Financial institutions have parallel service channels like physical branch networks, various agents, the internet, call centers, mobile devices etc. The principle should be that the customer can choose the channel(s) he/she wants to use. Kist [2001] prioritizes an IFS (see section 3) because of its ability to have multiple distribution channels that have the means to approach customers in a variety of ways, i.e. click, call, and face - as defined by Kist. Integrating various channels and inter-channel customer information transfer are challenges for a financial institution even without any alliance structure. More generally, customer relationship management (CRM) requires significant IT investments and continuous development. See also Kist [2001] for customer *value* management. A theoretical approach to CRM in insurance is given by Schäfer [2000].

5. *"Optimize cost and revenue synergies"*.
Scale benefits are obvious in the production of many financial products. They have traditionally been utilized by means of consolidation within the banking/insurance sectors. Cross-sector utilization evidently requires consolidation, too. According to Kist [2001], some ways to gain maximum advantage with an IFS (see section 3) are to integrate risk management activities across the group, develop consistent financial reporting performance measures across all business types, and implement shared services for technology, accounting, and human resources. A great source of synergy is the ability to combine the previously separate asset management functions across the company into a single management structure.

Among other reasons, changing customer behaviour tends to make it necessary to reduce service channels, most of all branch networks. Eliminating overcapacity is at least in principle a more straightforward action when one member of the alliance has control over the others. On the other hand, integration creates overlapping functions which have to be streamlined. In the case of looser alliances one-door-principle makes it possible to get rid of branch overload. For other cost and revenue synergies, see Kist [2001].

6. *"Minimize channel conflicts".*
A channel conflict can occur when the channels of alliance partners cross-sell each other's products to the same customers. Then the branch staff may think that the other party is stealing their provisions by cross-selling "their" product to their customer. Sometimes an alliance member can fear that when they have cross-sold a customer their partner's product, the partner uses the acquired customer information when selling him/her

another product competing with the original company's products. Channel conflict may also lead to fragmentation of the client base and/or ring-fencing of product offers (offers labelled "bank" or "insurance", see Benoist [2002]).

7. *"Optimize required solvency capital"*.
The return on equity (ROE) is one of the most important performance measures in financial enterprises. Therefore, company management must carefully optimize the relation between working capital and balance sheet. In Finland, this ratio is on the average ca. 10 % which means that the Finnish life insurance companies have the capital of two billion euros on top of the technical reserves. (Schroeder et al. [2001] show that unit-link insurance has improved profit margins compared with with-profits life insurance in France, Germany, the Netherlands and Belgium. One important reason is lower working capital requirement. Trapp [2003] calls for new business models for weakly capitalized insurance companies.)

Traditionally, one important incentive for mergers and acquisitons is diversification of business portfolio. In principle, a financial conglomerate has greater flexibility and greater opportunity for diversification than a simple combination (Kist [2001]). If there are several consolidated banks and insurance companies under the same control, it is crucial whether or not the different companies equalize or amplify each other's business cycles. In the latter case a group may be forced to complement its solvency capital as the bottom of the cycle approaches. This has caused serious discussion of the justification of cross-sector consolidation in many parts of Europe. It seems from practical experience that the business cycles of traditional (with-profits) life insurance and retail banking correlate strongly, but nonlife/risk life insurance and retail banking are less correlated (cf. Kist [2001], Kwan and Laderman [1999], Laderman [1999]).

Consolidated financial groups must have strong risk management capabilities. Information concerning risks can be used to determine the required levels of economic capital within each business unit and at the group level (Kist [2001]). Also, the succesful leveraging of risk management professionals between the banking and insurance businesses can create much synergy. Furthermore, banks and insurance companies can provide each other a partial hedge of their natural asset liabilities mismatch positions.

8. *"Maximize investor power"*.
If two companies are consolidated, the investor power is often more than doubled because certain fixed minority limits may be exceeded. For this reason, consolidated structures may be favoured because conflicting interests of independent partners might prevent them from utilizing this phenomenon in practice. Besides direct share ownership, also discretionary asset management and mutual fund management mandates give investor power.

9. *"Maximize the efficiency of sales management"*.
Centralized sales management obviously requires centralized organizational structure, i.e. consolidation. One might presume that this is a benefit compared to the decentralized management of looser alliances. However, some partners with a plain cross-selling agreement claim that they have succeeded in creating a very effective "cross-selling culture".

When we evaluate the attractiveness of the various alliance structures presented in section 3 in the light of the above nine criteria, we wish to point out that :

- Although the literature seems to favour financial conglomerates, it is by no means granted that they are optimal in all circumstances.
- Even if control by ownership should be preferred, it may be found to be difficult or impossible to implement. That is the case for example for many local banks and mutual insurance companies.
- It is certainly more attractive to control than to be controlled. In case of financial conglomeration the solution for the owners of a company to be acquired can be accepting shares of the acquiring company as the purchase price.

5 Expert interviews

We have interviewed the experts listed in section 7 and asked about their opinions on the alliance structure models and the criteria explained in sections 3 and 4.

One of the major benefits of tighter alliance models is that for example “control by ownership” prevents or at least strongly restricts channel conflicts. Some experts pointed out, however, that well written sales agreements minimize, if not totally prevent channel conflicts. Furthermore, protecting customer relations and fundamental business lines were considered more important than immediate returns.

It was generally acknowledged that the presented six models succeed in separating various real-life alliances quite well, at least in the Finnish market. In fact, as recently as last November there would have been Finnish examples in every category.

Several experts paid attention to the top management point of view in the MCDM problem. Some of them asked whether this is somehow different from the shareholder’s perspective. If the top management incentives are appropriate and good corporate governance is also otherwise followed, there is hardly significant difference. The situation may change if a shareholder has important holdings in several financial enterprises.

One expert remarked that the second criterion could be stated in a more general way, for example “create as effective sales channels as possible”. However, the author has noticed, while planning several financial alliances in recent years, that one-door-principle has always been among the objectives. The suggested generalization is actually a part of the ninth criterion.

An expert suggested a more descriptive name for the third criterion : “ensure as fair division of earnings and costs as possible”.

The fourth criterion could, according to an expert, be defined as “enable effective cross-selling”.

As already pointed out in section 4, channel conflicts should be understood so widely that they include conflicts between product companies. An expert suggested, with good reasons, that the sixth criterion should be called “minimize interest conflicts between service channels and between product companies”. Channel conflicts may occur also in financial conglomerates. For example, savings insurance and deposits compete for the same customers. This problem can be solved by good steering systems. For instance, salespersons should get sufficient reward for selling other business units’ products and creating succesful contacts between their customers and other business units. Thus, they become “group salespersons”.

The seventh criterion actually includes a whole MCDM problem, the most important objective of which could be “maximize ROI”. Here the time horizon is crucial. If solvency requirements for certain business lines are relatively lower than for other lines, there is a possibility for arbitrage.

The eighth criterion was given a minimal weight by some experts, while others remarked that even if institutional investors in Finland not so often participate in board working, they use their power in annual shareholders’ meetings. It is also becoming more common that they participate in board and compensation committee working. Finnish life insurance companies have, at least so far, been more active investors than, for example, fund management companies.

One of the experts suggested an additional tenth criterion: “Optimize the stable competitive position” Because many criteria already represent various aspects of this criterion, we decided no to add it. Another suggestion for a new criterion was “minimize the (negative) effects of the changes in operational environment”. We did not accept this criterion to our list, either, because it is not very concrete and, again, existing criteria cover several aspects of it.

One expert wanted to point out that now that we have, in a sense, nine objective functions, we should keep in mind the restrictions, i.e. licence regulations and minimum solvency requirements.

To summarize the interviews : The criteria are, obviously, partially overlapping, but no criterion covers totally another criterion. Therefore, there is no need to “merge” criteria. Inserting new criteria did not seem useful, either. Financial conglomerates may suffer from intrigues and sub-optimization, but these phenomena can be done away with by a competent management. One of the experts remarked that in other alliance models than “control by ownership” much better sales results can be achieved if there are other partners’ sales experts in the top management of each company. Finally, people are decisive, not only the model.

6 Conclusion

We have achieved an MCDM problem and are definitely interested to solve it. The question is how to rank the models in section 3 according to the criteria in section 4 considering that the criteria are difficult to quantify and measure in a harmonious way. One possible solution method is the analytic hierarchy process (AHP) by Saaty ([1980], [1990]). With the help of AHP we can compare the criteria pairwise and thereby prioritize them. We can also compare the models with respect to each criterion and finally prioritize the models. Pairwise comparison allows the use of both quantitative and qualitative criteria and the consideration of "soft" values. AHP has the added advantage that it allows the decision maker to monitor and control the inconsistency of judgements which is inevitable due to pairwise comparisons.

We plan to use AHP in an experts' meeting where the experts mentioned in the following section negotiate to reach consensus concerning the pairwise comparisons. The experts are top managers of Finnish banks and insurance companies which have implemented four out of six alliance models which we discuss in section 3.

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Matti Ruohonen	Managing director	Veritas Life Insurance
Pauli Sarelius	Deputy managing dir.	Okobank Life Insurance
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