



Cookson Walker Consulting

## The Bottom Line

**Will providing integrated financial services take your brokerage in the right direction? Success stories are common but be prepared to invest considerable resources and effort.**

By Eric Walker and Paul Greenhow

An increasing number of property and casualty brokers are venturing into the business of offering integrated financial services. These brokers have visualized the integration of financial services with their core services as an effective way to achieve growth, increase retention, and to provide a better service to their existing clients.

While those goals may be realized, the actuality is not as straight forward and may not be as profitable as one may think. In the end, the bottom line has to be the barometer of a successful foray into the financial services industry.

Depending on the approach that is selected to expand your p&c broker into an integrated financial services brokerage, there are many factors that you should consider before setting profit expectations and to best prepare yourself for the venture ahead.

Profitability increases with long-term and loyal customer relationships. Offering integrated financial services can enable you to evolve with your customers needs and promote stronger client relations. Yet measured steps are necessary as broaden your scope as reputation, success, and value must be conscientiously guarded.

### Number crunching

For effectively managed p&c brokers, pre-tax profitability levels can be in the range of 25 per cent to 30 per cent. A key factor affecting the profitability of a brokerage is the mix of the business. Commercial property business, personal property, and commercial and personal lines automobile business are unique and do not all contribute equally to the bottom line.

Non-auto commercial business generally contributes the highest profitability because it is dealt with in larger amounts, the commission rates are relatively attractive (15 per cent to 25 per cent and the cost of servicing these accounts is small relative to the size of the commissions).

Non-auto personal business usually achieves slightly lower profit margins -- despite attracting similar commission rates as non-auto commercial business -- due to the relatively smaller size of commissions generated per account. Because of the basic annual overhead cost in any insurance policy regardless of premium size, it follows that the profitability is lower because of the fixed cost of policy preparation and administration.

Personal and commercial automobile business traditionally yields the lowest margin for two main reasons. First, there is little complexity in automobile insurance and consequently, insurers pay brokers lower commissions in the range of 10 per cent to 15 per cent. Second, automobile ownership is broadly based and people are faced with compulsory insurance requirements so customers tend to shop among brokers for the lowest rates.

Many similarities can be drawn when comparing the financial services sector to the p&c sector. Revenue generation is based on an annuity type income and is dependent on client retention. Cost allocations can be similar and profit margins may or may not be in the range of those for p&c brokers.

On the revenue side, while p&c commission income is earned smoothly, several financial products, including types of life insurance, mortgages, and mutual funds, have heavily weighted up-front commission income structures. These affect both the timing of cash flows and the incentives for producers and customer service representatives to pursue the business.

On the cost side, compensation of financial advisors is typically in the range of 50 per cent to 75 per cent of both new and renewal commission income. Although compensation costs are high, product providers absorb a significant portion of the overhead expenses. Overhead to the broker tends to contain a low level of fixed costs. Faced with this cost structure, it is increased commission volume that enables a financial services business to realize margins in the range of 10 per cent to 20 per cent. Achieving the necessary volume levels could take up to five or seven years if the business is built from scratch.

Commission income rates and margins for term accounts and deposits are typically thin. With interest rates so low there has been downward pressure on the commission rates extended to the investment advisors. The corresponding costs are low as the typical transaction is routine and does not require a licensed representative or consultation.

Life insurance can take many forms, however, only term life policies are addressed here. Typically, a heavy up-front commission is paid for term life insurance (in the range of 100 per cent to 200 per cent) with little or no renewal commission, which usually expires after a few years. Costs tend to be incurred proportionately with the commission income earned, such that once a policy is set up, there is little consultation, and licensed representatives are not required. Margins can be very high for term life insurance, however, charge backs are common and can be very difficult to absorb when there is no offsetting income.

Mortgages are very similar to the characteristics of a life insurance policy, with respect to revenue and expense allocations, timing and margins. Commissions are based on the size and term of the mortgage with a fee in the range of 3 per cent paid up front on closing.

Mutual funds take many forms. Depending on the structure and agreements set with a given fund company, commission income can range up to 1 per cent of total assets, and can include an up-front fee of about 5 per cent. Service costs are generally low given the long-term perspective most investors have when holding mutual funds. Mutual fund

companies are putting downward pressure on margins due to reduced commission rates.

The benchmark return on investment (ROI) in the insurance industry is in the range of 20 per cent (pre-tax). This is consistent with the standard industry rules of thumb for valuing different lines of business, being multiples of commission income to value a book of business. The standard rules of thumb prescribe average multiples of commission income ranging from one to two times depending on a multitude of factors, however, they are primarily based on the type of business. A pre-tax ROI of 20 per cent when using average industry multiples of approximately 1.5 (average of one, one-and-half and two times) implies that the investment would earn a return on commission income in the range of 30 per cent.

When considering a financial services business, similar benchmark ROIs should be sought. Given the lower margins, lower average multiples in the range of one time are generally found in the marketplace for books of business based on commission income. Thus, a pre-tax ROI of 20 per cent when using an average industry multiple of one implies that the investment would earn a return on commission income in the range of 20 per cent.

### **Benefits**

One of the main advantages of expanding into integrated financial services is the opportunity to cross sell. Given that a solid customer base already exists, a certain percentage of the existing clients could be successfully sold other financial products. Sales costs would be low for your existing client base, however, a systematic and thoroughly planned selling approach is essential to ensure maximum hits from these targets.

Another benefit is the fact that numerous studies have confirmed that multi-line clients have much higher retention rates, which results in increased revenues, reduced selling costs, and will ultimately improve profit and value. As well, there can be increased revenue per client. By offering more products and services, it follows that revenue per customer will rise, having a positive impact on your brokerages margins. Branching out also requires limited investment in capital as initial costs are restricted, with the possibility of financing a portion of these up-front costs from operations.

A move towards integration does not have to be a dramatic change – you can set your own pace. Because you have a base p&c business, slow and measured initiatives can be made and products can be introduced in stages, allowing the brokerage to adapt and evolve with the new products. This will limit the “shock” factor on the bottom line as well as with clients and office culture.

### **Drawbacks**

On the negative side, you must consider return on investment. Growth into the financial services business through cross-selling will take a significant amount of time, capital, resources and effort before you will enjoy the fruits of your labour. Positive income and cash flow may not be realized until after five years of hard work, or more. A short-term outlook will surely end in disappointment.

As well, offering a full suite of financial products alone will not increase value. To be a jack-of-all-trades and master of none will not develop a favourable reputation in the industry, especially given the current market conditions. Credible and reputable advice is required which involves planning, strategizing, hiring and/or training, all of which involve time, and money. Marketing the new services must be addressed including promotional material and mailings to keep all contacts informed of the changes.

Moreover, there is a learning curve. Investing and insurance cultures are very different and employees will have to adapt to cross-functional, cross-business units where the old parameters and barriers are obsolete. These changes can be highly stressful and top-level support is critical to ensure that the objectives of the changes are communicated throughout the company.

Additionally, systems must be in place to ensure effective and efficient deployment of management time and resources as any misallocation will not only hurt the bottom line but will send a misleading or negative message to staff. And the issue of contacts and contracts must be addressed. While affiliation with one main contact is the likely scenario under a packaged program approach, other approaches to establishing a financial services business (eg. starting from scratch, buying an established business, hiring accredited professionals) will require a significant amount of time and effort to initiate new contacts, outline and finalize contracts, and nurture business relationships.

Will providing integrated financial services take your brokerage in the right direction? Success stories are numerous but the answer to this question is different for every p&c broker.

In the financial services industry, lower margins are offset by increased retention with multi-line clients. The potential can be promising, however, be prepared to put forth time, capital, resources and effort before realizing the returns common to a p&c business.

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