

# **Insurance Companies in the U.S. and U.K. Enter the Banking Business**

by Yoshiko Amano  
Insurance Research Group

John Downing, head of electronic distribution at Lloyds TSB, says: "We are looking very carefully at Egg. The internet has really started to come to the fore."

"Egg" is a new brand of financial services provider that has attracted attention in the U.K. since its debut in October 1998.

With the fall of regulatory barriers separating banking and insurance, most people assume that a one-sided surge will occur as banks enter the insurance business. But in the United States and United Kingdom, not all insurance companies are necessarily on the defensive; a growing number of them have recently established bank subsidiaries.

This paper focuses on developments among insurance companies setting up bank subsidiaries. The main problem insurance companies face when they enter banking is deciding how their insurance agents should treat deposits. We look at two contrasting approaches by the largest life insurer in the U.K., Prudential, and the largest property and casualty insurer in the U.S., State Farm, to gauge the overall progress of this new trend.

## **2. Prudential's Foray into Banking**

### **1. Stage 1 – Establishing a Bank Subsidiary**

U.K. banks began entering the insurance business as a result of financial deregulation in the 1980s. In the late 1990s, major life insurers in turn began establishing bank subsidiaries. Following the successful example of a supermarket's bank subsidiary, they conducted business not through branch offices but through marketing channels such as agents, IFA (independent financial advisors), telephone and mail. Their competitive strength lies in avoiding the high cost of maintaining branch offices and in offering high interest rates. However, the primary aim was to prevent maturity proceeds from flowing out of the group. The strategy worked, and the deposits of bank subsidiaries grew steadily.

**Table 1 Bank Subsidiaries of Life Insurance Companies in the U.K.**

	Prudential	Standard Life	Scottish Widows	Regal & General
Industry ranking	1	2	4	6
Establishment date	Oct 1996	Jan 1998	May 1995	Jul 1997
Non-agent channels	Internet, phone, IFA	Phone, IFA (Internet under dev.)	Phone, IFA	Mail, phone
Deposits				
Mortgages				
Personal loans		x	x	x

Source: *Retail Banker International*, June 1997, and company web sites.

## 2. Stage 2 – Emergence of the Egg

In October 1998, Prudential took a big step in developing its banking business by introducing the Egg.

### (1) What is the Egg?

The Egg is a new financial services brand begun as a part of Prudential Banking (as opposed to being a new company). It offers personal financial services such as deposits and loans over the Internet, by telephone, and by mail. It mainly targets the younger segment of Internet users. Since its inception, it has grown prolifically, and as of this July held the top rank in online accounts among domestic banks, and was the only U.K. bank in the top ten internationally.

### (2) Relationship between Prudential Bank and Egg

At the time of its establishment in 1996, Prudential Bank had no branch offices. Its primary marketing channel was direct contact between agents and customers, with telephone and mail contact playing a secondary role. It offered savings deposits, 60-day time deposits, and mortgage loans, with the purpose of keeping Prudential's six million policyholders from withdrawing their funds from the group when their policies matured. Mainstream customers have cultivated a preference for dealing with Prudential's agents and obtaining financial advice. While deposits showed strong growth at first, they have recently leveled off.

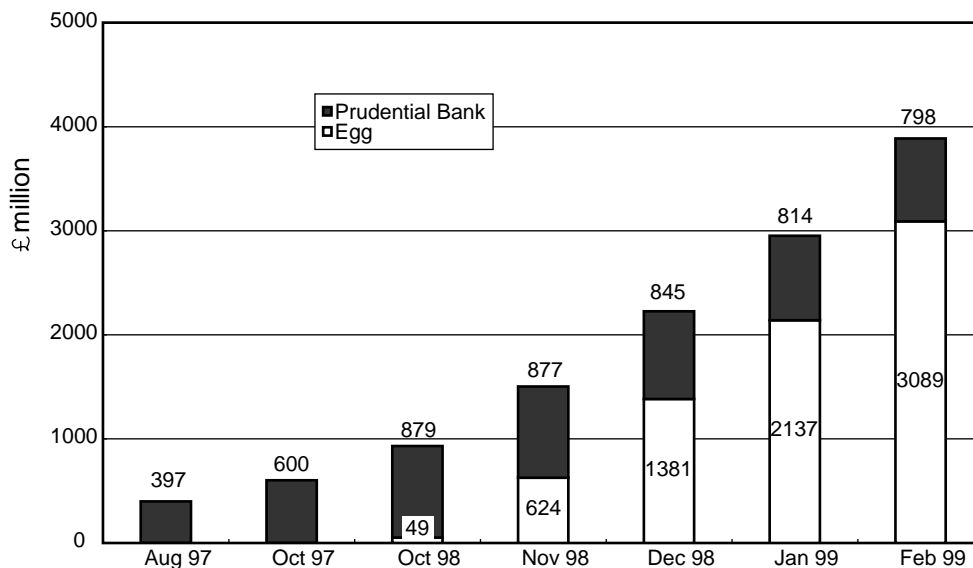
Egg, on the other hand, targets a wealthy but younger segment of customers who are not drawn to the Prudential brand. Thus Egg has deliberately avoided using agents and has disso-

ciated itself from the traditional Prudential image. While organizationally a part of Prudential Bank, its operation is independent. Using the Internet, telephone and mail as marketing channels, it is open 24 hours a day, and thus far more convenient than Prudential Bank's traditional bank hours.

### (3) Sharp increase in depositors

The customer response to Egg has exceeded all expectations. The call-in center was overloaded and broke down as soon as it opened, causing customers to wait 28 days to set up an account. As Figure 1 shows, whereas Prudential Bank has maintained deposits of approximately 800 million pounds, Egg's deposits have grown explosively. In the first six months, it met its 5-year goal of half a million customers and 5 billion pounds in deposits (and reached 6 million pounds). In 1999, Egg set a new 5-year target of 2 million customers.

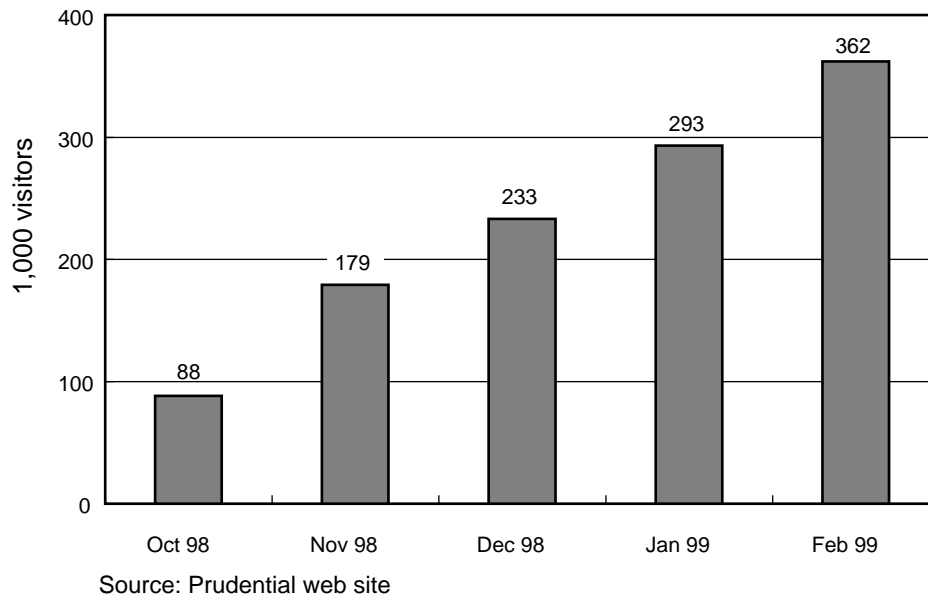
**Figure 1 Egg's Deposits**



Source: Prudential web site

The number of visitors to the Egg's web site has also grown monthly, reaching 400,000 views in March 1999. The web site, which is being constantly improved to attract younger customers, features the appearance of popular sports stars and DJ personalities.

**Figure 2 Egg Web Site Visitors**



(4) Egg's financial products and services

At first, Egg offered three categories of financial products: savings deposits, mortgage loans, and consumer loans. A fourth category, travel insurance, was added in February. Future product offerings under consideration include settlement accounts, insurance/investment/retirement products, credit cards, and information services related to daily life (school information, etc.). Egg's products have two basic characteristics: (1) the product lineup is simple and accessible to customers, and (2) each product is thoughtfully designed for convenience (Table 2).

**Table 2 Egg's Financial Product Lineup**

Product	Features	Advantages
Savings deposit	Variable rate only	Even higher interest rates without a cash card (checks are common in the U.K.). Competitive interest rates are offered with minimum deposit of £1.
Mortgage	Variable rate, 3 & 5 year fixed rate	Choices include variable monthly payments and length of loyalty period (up-front cash bonus of principal x 0.5% x no. of years up to 20). Flexible repayment methods.
Consumer loan	Sliding scale for interest rates on loans from £ 1,000 to £ 5,000.  Fixed interest rates	After six months of monthly repayment, customer can take payment break (up to 3 months in a 12-month period).  Loan payment protection is available. This provides insurance against accident, illness, death, and unemployment as well as a reemployment support program that includes counseling.
Travel insurance	1 type (package covers winter sports, business trip, cruise, etc.)  3-part price structure to age 75: £99 for singles, £135 for couples, and £149 for families (up to 8 children).	Annual renewal  For married couples and families, insurance coverage lasts up to 17 days per year even if partner travels alone. Fringe benefits include discounts for airport hotels, parking fees, and retained driver to airport.

Source: Egg web site

In addition, because of its Internet-centered business model Internet, Egg strives to make its www.egg.com web site as sticky as possible to attract repeat visitors. To do so, it offers not only financial products but the following services on its web site (Table 3).

**Table 3 Features Designed to Attract Repeat Visitors at Egg's Web Site**

Services to attract customers to web site	Description
Customer forum	Customers can discuss money issues
Net book shop	Discounts on purchases of financial books
Asset management business	Customers can view policy and account information online
Discount PC sales	Collaboration with Fujitsu

Source: Egg web site

## (5) Competitive interest rates

### 1. Competitive interest rates designed to attract younger customers

The primary factor that enables Egg to powerfully absorb personal assets are the competitive interest rates it offers (both high deposit rates and low lending rates). Initially, Egg offered a mortgage rate that undercut competitors by at least 1%, a deposit rate (without a cash card) of

8%, and a variable mortgage rate of 7.99%, in effect setting the deposit rate higher than the mortgage loan rate. Following several rounds of policy interest rate cuts by the BOE, Egg also lowered its deposit rate (without cash card) to 5.75% as of July 22, thereby honoring its original commitment to set the deposit rate 0.5% above the policy rate.

**Table 4 Comparison of Mortgage Rates (May 17, 1999)**

Leading financial services companies in England	Affiliation	Capitalization (£ bil.)	Variable interest rate
Cheltenham & Gloucester	Lloyds TSB (former building society)	68.6 *	6.85
Barclays	Bank	32	6.85
National Westminster	Bank	29.9	6.89
Egg	Prudential Bank	29.9 *	5.99
Halifax	Former building society	29.4	6.85
Abbey National	Former building society	27.4	6.85 ~ 6.95
Regal & General	Insurance	18.4	6.85
Royal Bank of Scotland	Bank	14.9	6.1

Note: \* Capitalization of group

Source: Compiled from company web sites, and Solomon Smith Barney.

**Table 5 Egg's Initial Savings Deposit Rates**

**Can use cash card**

Deposited amount	Financial institution	Affiliation	Interest rate (Oct. 29 '98)
1 –	Egg	Insurance	7.50
1	Nationwide	Building society	7.40

\* Egg has ATM tie-ups with Midland Bank and others.

**Cannot use cash card**

Deposited amount	Financial institution	Affiliation	Interest rate (Oct. 29 '98)
1 –	Egg	Insurance	8.00
1,000	Cheltenham & Gloucester	Former building society	7.50
2,500	Safeway	Grocer	7.55
10,000	Saga	Insurance	7.75
20,000	Halifax	Former building society	7.80
25,000	Saga	Insurance	7.85

Source: Egg web site

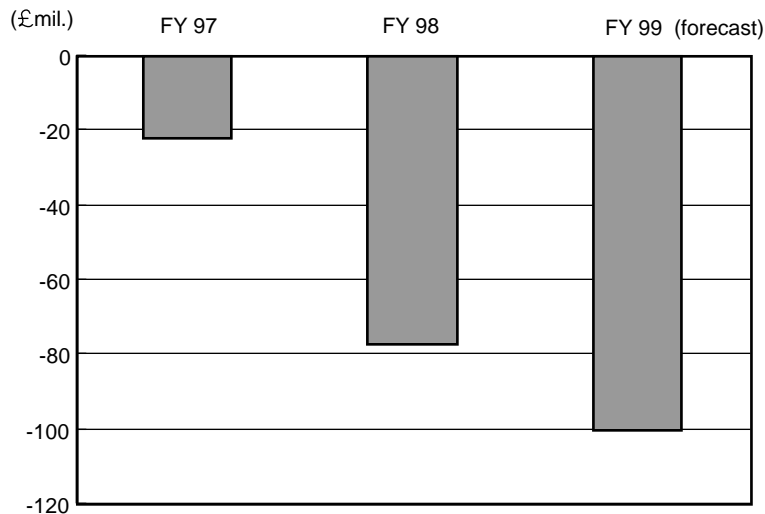
## 2. Low cost structure

Egg's favorable interest rates are made possible by a thoroughgoing low cost structure. Compared to conventional banking, telephone banking can be operated at one-fourth the operating cost, and Internet banking at one-tenth the cost. Moreover, to further reduce costs, since the end of April deposits are handled only on the Internet.

## 3. Profit is not an immediate priority

Losses in the first two years of operation are expected to reach 175 million pounds due to the massive initial investment cost and aggressive strategy of building its assets and customer base by going so far as to initially set the deposit interests rate above the variable mortgage rate. The interest rate reversal was maintained until mid May with a willingness to incur losses to gather highly liquid retail funds and build a solid customer base.

**Figure 3 Prudential Bank's Pre-tax Loss**



Source: Prudential

## (6) Prudential's channel strategy

Prudential's channel strategy appears to be intimately involved in the design of Egg. Improper sales of annuities in 1993 in the U.K. greatly diminished the public's confidence in life insurance. When life insurance sales rules were tightened in 1995, the cost of maintaining a dedicated sales force rose and sales efficiency suffered. This led to sharp cuts in the sales force, which for life insurers is the main sales channel (Prudential alone slashed its sales force by 12,000 to 13,000 in the decade after 1989). Meanwhile, sales shifted to IFA and other alternative channels.

Being the industry leader, Prudential was subjected to the brunt of investigations brought against life insurers, and its image of exceptional customer service (the “man from the Pru”) was severely tarnished.

Over the next two years, Prudential worked out a new strategy based on a year-long study of 5,000 customers (with an amazing response rate of almost 100%). The study examined their decision making on financial products and preferences for financial services, and produced two predictions: (1) by 2013, two out of three persons will be purchasing financial products in electronic marketplace; and (2) 15 million persons ranging from young wealthy persons to persons near retirement will show an interest in electronic banking.

In establishing Egg, Prudential integrated a marketing channel with a unique brand image. Prudential overall branding strategy as announced by the company is shown in Table 6.

**Table 6 Branding and Customer Segments**

	<b>Prudential brand</b>	<b>Scottish Amicable brand</b>	<b>Egg brand</b>
Marketing channel	Agents	IFA	Internet
Customer segment	Existing customers who prefer agents	Customers who prefer an IFA financial accountant	Young, wealthy persons who can access the Internet
Fiscal 1998 sales ratio	35%	60%	5%

Source: Prudential web site

**3. State Farm’s Bank Subsidiary – Maintaining the Agent Network**

State Farm, the largest property & casualty insurer in the U.S., takes a contrasting approach to Prudential regarding the use of agents. Emphasizing traditional themes, State Farm has chosen to fully mobilize its network of agents.

While little known in Japan, State Farm boasts leading market shares of 20% in its core retail businesses of automobile and fire insurance. Moreover, in 1998 its life insurance subsidiary, State Farm Life, was ranked third in new policies. State Farm’s formidable network of well trained, carefully deployed agents consistently overwhelms competitors.

(1) Boom in Thrift License Applications

The U.S. Congress has passed a financial reform bill that will eliminate the barriers prevent-



ing banks, insurance companies, and securities companies from entering each other's business, and the bill now is in the final stage of compromise. However, banks have in practice already entered the insurance business. Since annuities are treated not as insurance products but as investment products, banks have been allowed to sell them, and have captured a 20% share of all annuity sales.

What has challenged the advantageous position of banks entering the insurance business are the thrift institutions formed by insurance companies. Despite the fact that thrifts operate in essentially the same way as banks, unlike banks, they can be owned as subsidiaries by insurance companies and securities firms. In the course of financial reform, many insurance and securities companies took advantage of this point, causing a rush in thrift applications.

**Table 7 Approval of Thrift Applications (June 30)**

Year	No. of approvals
1997	56
1998	89
1999	29
Total	174 (of which 77 are not traditional banks)

**Table 8 Thrift Applications by Companies Other than Banks**

	Insurance	Securities	Manufacturing	Telecom	Other	Total
Approvals	41	14	7	1	14	77
Current applications	19	7	4	0	8	38

**Table 9 Major Thrift Players Among Insurance Companies**

Insurance co.	Name of thrift	Approval date	Business description
AIG	AIG FSB	Mar 97	Wide range of financial services to policyholders
Principal	Principal Bank	Nov 97	Personal deposits and loans over the Internet
GE Capital	GE Capital Bank	Switched from bank Dec 97	Wide range of financial services
State Farm	State Farm	Nov 98	Deposits and personal loans through network of agents
Guard	Guard Security Bank	July 99	Personal loans including consumer loans

Source: Compiled from OTS thrift application summary.

Having received approval to operate a thrift in November 1998, State Farm established State Farm Financial Services, which began banking operations in May 1999 as a wholly owned thrift subsidiary.

## (2) State Farm Bank

State Farm Bank began operation in May, and presently operates only in Illinois and St. Louis. According to the business plan, it will expand across Missouri and Illinois within two years, move into Arizona in the third year, and ultimately expand nationwide like its parent company. Its objective is to supplement and reinforce a retail intensive strategy. By enhancing its retail product lineup, it aims to focus on selling consumer oriented financial products throughout the entire group.

## (3) The Agent Network

Like Egg, State Farm Bank has no branch offices. What it does have at its disposal is the parent company's 16,000-strong network of insurance agents to support transactions with customers, assist with the use of communications services, and act as a window for loan consultations. The head office is located on the same premises as for State Farm, and approximately 10 State Farm employees and agents, while dedicated service providers offer full service banking. Customer access through mail, telephone, and ATM (whose use is limited to areas with ATMs owned by State Farm) agents provide support in the capacity of consultants. The nearest agent can be found by consulting the web site. However, to further improve customer convenience, the company has announced that it will start online banking services in the fall.

## (4) Starting with Simple Product Offerings

The bank's product lineup consists of savings products (savings account, investment account, and CD account; however, limited checking accounts are offered to employers, agents, and agent staff) and loans (mortgages, home product loans, credit card loans, and automobile loans). Customers have enjoyed access to State Farm's ATMs from the start, and both debit cards and credit cards will become usable in the second half of the year.

### *1. Deposit products*

Users can conduct transactions through the mail, ATMs, and by telephone. Although the agent cannot accept deposits, they can accept and deliver mail addressed to SFB. New accounts can be opened with small amounts, and statements are sent periodically. In addition to competitive interest rates, the low minimum account balance, and the low account maintenance fee in case

deposits fall below the minimum level. For savings deposits, this fee is waived for the first two months (interest is paid down to minimal balance).

**Table 10 Investment Account Yields (July 28)**

Average daily account balance	Monthly acct. maintenance fee	Annual rate	Illinois bank average
\$0 - \$99	\$10	0.00%	2.82% if less than \$10,000; 3.22% if more
\$100 - \$999	None	4.10%	
\$1,000 - \$4,999	None	4.52%	
\$5,000 - \$24,999	None	4.83%	
\$25,000 +	None	5.25%	

**Table 11 CD Yields (July 28)**

Period	Annual rate for under \$100,000	Annual rate for over \$100,000	Illinois bank average
90 day	4.70%	4.91%	4.08%
180 day	4.91%	5.12%	4.45%
1 year	5.18%	5.34%	4.81%
2 year	5.84%	5.95%	5.07%
3 year	6.02%	6.08%	5.18%
5 year	6.09%	6.09%	5.34%

Average daily account balance	Monthly account maintenance fee	Annual rate
0 - \$99	\$5.00	0%
\$100 +	None	4.08%

Source: Compiled from State Farm web site and MSN Money Central.

## 2. Loans

Due to the parent company's experience as a p/c insurer, the product composition heavily features mortgages and car loans, while peripheral services are also enhanced (for example, car leases). Since loans must always be arranged by an agent, the company web site's loan information page is linked to a search engine that locates agents by entering the zip code or area.

### (5) State Farm's Strength

Two months into the bank's operation, results are not as clear-cut as with the Egg. However, SFB emphasizes the following merits with respect to customers.

1. Boasts capital strength based on strength of parent company.
2. Offers one-stop shopping for a variety of financial services.
3. Reliable agents have full access to customer information to better support customer's use of services.
4. 24-hour, year-round operation.

The third factor is particularly large. According to the company, SFB's agents are locally based and can boast strong ties with customers. When selling car or home insurance, they also play a role in arranging financing. Although the ordinary sequence is to obtain a loan before buying insurance, customers first actually visit the agent's office. This indicates the strong intimacy between customers and agents. In the future, agents will also be able to offer loans to customers. Thus State Farm Bank promises to secure a large number of loan customers simply by absorbing the insurance customers introduced so far.

#### **4. Conclusion**

Amid the emerging cross-entries among banks and insurance companies, we have introduced two contrasting cases of how major insurance companies have established bank subsidiaries. Despite significant differences in how corporate brands and sales forces are used, both cases share a 24-hour, year-round operation, and have enhanced product competitiveness by eliminating costly branch offices. Progress in information technology has played a large role in the background. Thus by acquiring e-commerce capabilities equal to banks and securities companies, major insurers can leverage their financial strength and vast networks to open up new business opportunities.

This October, insurers in Japan will be allowed for the first time to establish bank subsidiaries. While prevailing ultra low interest rates tend to complicate matters, bank subsidiary strategies need to study cases from abroad to develop fresh perspectives and figure out how best to mobilize the sales force.