

## Industry Trends

Late 2003 found the financial services industry leveling out after a tumultuous few years in 2000-2002. Stock markets were crawling back, regaining some ground from spectacular losses. Property and casualty insurance underwriters moved back into profitability in 2002 after unprecedented losses the previous year. Interest rates remained quite low, although up from a low point which occurred in June 2003. Investment bankers and stock brokerages seem to have put the stock market crash, stock analyst woes and accountability problems of 2000-2002 behind them, and layoffs in that sector have leveled off. Even tech stocks and online trading were gaining ground, well off their low points, while the occasional IPO was finding success. Venture capitalists are starting to open their wallets again, but at much lower levels than during the boom of the 1995-2000.

Despite this relatively good news, there are still major concerns within the financial sector. For example, the level of consumer debt is terrifying and the number of personal bankruptcies reached an all-time high during the 12 months ending on June 30, 2003: 1.61 million filings, up 30% over the previous 12-month period. (Consumers have been encouraged to take on debt due to very low interest rates and the ready availability of loans of all types.)

Battered by falling values in their stock portfolios, mutual fund investments and 401(k)s, individual investors have greatly lowered their expectations of future returns on their investments. Many have turned to real estate for a large portion of their portfolios, snapping up rental houses, bigger primary residences and second homes, driving up home values in the process. Others have steadfastly continued to pump money into their retirement accounts.

Corporate profits are up, but are not particularly impressive, and stock investors will be challenged not to pay too much on an earnings-per-share basis. Corporate debt levels are high, but companies have been doing their utmost to take advantage of recent low interest rates to reduce borrowing costs. Banks and most other lenders appear to have learned hard lessons in recent years and generally are earning good profits.

Over the mid-term, the health of the financial sector will depend largely on the ability of the global economy to recover and find growth; slow, steady growth would be enough to enable most borrowers to repay their debts in a timely manner. However, several threats remain in the distant background, including worries about potential inflation, terrorism, political upheaval and the fact that many U.S. workers are unable to find suitable employment.

Wall Street's image was only briefly tarnished by investor lawsuits and analyst scandals after the stock market crash of 2000-2001. The stock market is still where most investors focus their portfolios, and Wall Street holds the key to the markets. The biggest challenge in the investment sector will be avoiding another bubble/crash scenario. For example, in the first eight months of 2003, NASDAQ stocks recovered to the point that price/earnings ratios for stocks listed on the exchange had reached very lofty levels. If corporate earnings can't keep up with the growth in stock prices, investors will once again wake up to the fact that they are paying too much for stocks and the market could plunge, shaking the entire financial sector to its core.

Meanwhile, savvy firms are latching onto the latest in technology to streamline back-office tasks and online services, taking advantage of higher stock values to make acquisitions and fine-tuning their product offerings to position themselves for the future. A quickly growing trend is offshoring—the use of low-cost overseas workers to run call centers and handle back-office tasks. Technology, cost control, consolidation and an increased consumer interest in accessing financial accounts online will drive the financial sector over the next several years. The result will be bigger firms controlling bigger chunks of global market share, driving productivity at every chance. At the same time, upstart companies with innovative value-added products and services have a tremendous chance to succeed in a big way. (For example, look at the recent success of PayPal, or the booming business enjoyed by specialty insurance underwriters that service unique niche markets.) Interesting times are ahead for the financial sector, and a handful of dominant trends will be driving significant change between 2004 and 2010. Additional details follow.

**1. Increased Fee Revenue is the Goal as One-Stop Shopping is Offered by Financial Services Firms, including Banks plus Traditional and Discount Brokerages--Meanwhile, Financial Planning and Private Banking are Targeted**

In an ever-increasing effort to expand market share, major banks and financial firms are diversifying to offer as many financial services as possible, thereby amassing more revenue from existing clients and new clients alike. Merrill Lynch is an excellent case in point. The financial services giant was once an undisputed global leader in investment banking and brokerage. Today, the company is facing fierce competition in the brokerage business (particularly from discount brokers) and in the investment banking business. Now the firm offers a vast variety of services and financial products as a means to boost revenues and hold onto customers. Merrill Lynch's products for consumers include mutual funds, asset management, financial planning, insurance, annuities, trust services, cash management accounts and mortgages. These fee-generating services enable the company to count on a reliable income stream during periods when stock markets are performing poorly and stock trade commission revenue is therefore down.

**2.**

In fact financial planning and private banking have become two of the most competitive services in the finance and investments business. Virtually all major banking and investment companies have focused on selling financial planning services as a way to generate extra revenues and lock-in long-term customers. Individual investors, disillusioned by the market crash of the early 2000s and suddenly much less confident in their own investment prowess, have been eager to get professional help. At the same time, money center banks and large investment firms have targeted wealthy individuals with increased intensity in hopes of creating private banking relationships. Generally, such firms have seen households with \$10 to \$25 million as an overlooked market, and banks and investment houses have recently hired legions of pros to call on these families in an attempt to provide all of their financial needs in exchange for lucrative fees.

Citigroup, the largest financial services firm in the world, has long offered banking services through its Citibank subsidiary. It's also putting pressure on Merrill Lynch and other brokerage firms by offering its own asset management and investment banking services along with a wealth of financial products aimed at businesses and consumers.

Even discount brokers have been diversifying their offerings of services. E-Trade Group, Inc., for example, has gone far beyond its discount trading services to add mortgage lending, banking, employee benefit plan management and the nation's largest independent network of ATMs.

The Banking Act of 1933, frequently referred to by the names of its authors Glass and Steagall, made it illegal for banks and securities firms (investment banks) to have the same ownership. In 1999, the Gramm-Leach-Bliley Act, also known as the Financial Services Modernization Act of 1999, removed this 60-year-old barrier. As a result, from 1994 until 2002, there were more than 620 mergers and acquisitions involving U.S. securities firms, according to the Securities Industry Association ([www.sia.com](http://www.sia.com)). This merger activity was fueled partly by the desire of banking companies to diversify into the stock business and partly by financial companies picking up brokerage firms on the cheap that had been pummeled by the market crash of 2000-2001.

## **2. Branch Banking Booms**

Branch banking is exploding across the country. Banks which had formerly invested heavily in online banking have learned that customers also demand the convenience of neighborhood branches and drive-up windows. Banks are improving their e-commerce sites while pouring capital into more and more branch locations. In Chicago alone, for the 2002-2004 period, Bank of America planned to open 50 branches, Washington Mutual planned 70 new branches and BankOne planned 13. Nationwide, Bank of America leads the pack with 350 new branches planned to open for 2003-2004. Washington Mutual planned to open a total of 240 branches during 2003. Since the collapse of the Internet boom, bricks and mortar are once again a focus for expansion, despite the fact that the popularity of online banking is growing rapidly.

Taking a page from the retail industry, banks are equipping their locations with a host of entertaining and service-oriented conveniences. The latest branch banks have been carefully designed to emulate hip retail stores. In them, consumers may find coffee bars, water and snacks such as popcorn, children's play areas, retail kiosks with logo-encrusted items such as t-shirts, caps and pens for sale and pleasant music playing in the background. Gone are the days of hushed, austere banking. Today's bank lobby is friendly and inviting. The key is to lure customers to stay longer and sign on for more services (such as mortgages, investment management, insurance and annuities) while munching on popcorn and letting the kids play.

## **3. Property and Casualty Underwriters Recover from a Disastrous 2001**

The U.S. property and casualty insurance market (including fire, extended coverage, liability and similar losses) totaled approximately \$369 billion in net written premiums annually during 2002, up from \$340 billion in net written premiums during 2001 and \$297 billion in 2000.

4. While intense competition kept property and casualty insurance premium rate increases low during much of the 1990s, significant casualty losses relating to hurricanes, asbestos-related claims, earthquakes, terrorism, increased jury awards in lawsuits and other factors hampered the ability of many firms to earn profits. The atmosphere for rate increases changed considerably in early 2001, as the industry became more intent on earning profits and thus increased rates accordingly. Nonetheless, casualty losses were so high during 2001 that the industry posted its first recorded yearly loss (about \$7 billion). For example, one

major insurance firm, CNA Financial, reported that it had recorded a \$1.2-billion charge in August 2001 to add to reserves for losses stemming from asbestos, environmental and tort claims. Most property and casualty insurers had similar problems.

## 5.

After the devastatingly expensive terrorist attacks of September 11, 2001, rates on many types of coverage increased dramatically. Consequently, 2002 saw average rate increases of 16% or more. Additional factors leading to large rate increases include higher damage awards for workers' compensation claims and large claims for mold damage by homeowners in the South. Many customers seeking to renew policies now find that insurance is no longer available under previous terms and rates or is not available at all due to changes in the market as a result of these and other factors.

The attack on the World Trade Center created the largest insured loss in history, with covered losses estimated to run from \$30 to \$70 billion, including \$5 to \$6 billion in life insurance claims. The second-largest insured loss in history was the damage caused by 1992's Hurricane Andrew at \$20 billion (adjusted for inflation to equal 2001 dollars). Another development that occurred shortly after the World Trade Center and the Pentagon were attacked was a sharp spike in the sale of life insurance products.

The Insurance Information Institute estimates that rates for coverage of private homes rose by approximately 8% in 2002 and will rise by 9% in 2003. For automobiles, 2002 saw a rise of 8.4%, and are expected to rise by 9% in 2003.

The increase in rates is largely responsible for property and casualty insurers' recovery from the losses of 2001. The real proof of recovery for American underwriters lies in the industry's net income figures: \$2.9 billion in profit in 2002 versus a loss of \$6.9 billion the previous year.

The future for this sector is cautiously optimistic. While premium volume is expected to grow in 2003, the return on investment portfolios remains to be seen. Insurance companies earn a substantial portion of their profits by investing the dollars received from premiums until such time as those dollars are needed to pay claims. Generally, these investments are made in a carefully managed combination of short-, medium- and long-term assets, which include stocks along with bonds, loans and various types of interest-bearing assets. These portfolios may also include interests in such things as real estate and venture capital. The state of stock and bond markets has a significant impact on insurance company profitability.

## 4. U.S. Homeowners Refinanced Vast Amounts of Mortgages during 2002-2003

Homeowners generally refinance their mortgages either to take advantage of lowered interest rates that may lead to smaller monthly payments or rising home values that have caused a hike in their home equities. The 2000 to mid-2003 period saw a rare combination of intense pressure from both factors. That is, America was in a period of quickly falling interest rates combined with rapidly rising home values. A homeowner purchasing a \$200,000 home during the last week of December 1999 might have engaged in financing something like this:

Date of Purchase: December 29, 1999  
Home Price: \$200,000  
Down Payment (20%): \$40,000  
Mortgage: \$160,000

Interest Rate: 8.02%  
Monthly Payment: \$1,176  
Equity: \$40,000

Refinance #1:  
December 28, 2000  
Home Value Appreciation (past year): 10%  
Current Home Value: \$220,000  
New Equity: \$60,000  
New Mortgage: \$176,000  
Cash Taken Out of Equity: \$16,000  
New Interest Rate: 7.09%  
Monthly Payment: \$1,182

Refinance #2:  
June 18, 2003  
Home Value Appreciation (past 18 months): 13%  
Current Home Value: \$248,600  
New Equity: \$72,600  
New Mortgage: \$198,880  
Cash Taken Out of Equity: \$22,800  
New Interest Rate: 5.00%  
Monthly Payment: \$1,068

This scenario assumes that the homeowner was in one of many U.S. metropolitan areas that saw bounding increases in home value, and that the homeowner refinanced with new mortgages equal to 80% of the current value of the home. The cash taken out of equity is not adjusted for mortgage closing costs. The monthly payments shown in this example are based upon the average interest rates charged nationwide at the time of refinancing. Refinancing #2 was done when interest rates were at their bottom in June 2003. As you can see, over the entire two and one-half year period, the homeowner was able to 1) reduce his interest rate by more than 3%, 2) watch his home value grow by \$48,600, 3) withdraw \$38,800 in cash from his equity through refinancing and 4) lower his monthly payment by \$108 thanks to plummeting interest rates. It's easy to see why cash put into consumers' pockets through refinancing has fueled the economy in recent months. (Of course, the homeowner is also \$38,800 more in debt than he was when he first purchased his home.)

This same rapid rise in home values has enabled consumers to obtain substantial home equity loans even if they didn't want to go to the trouble of refinancing their primary mortgages.

During 2002, U.S. consumers took almost \$200 billion of equity out of their homes through mortgage refinancing, a trend that was largely responsible for the overall health of the U.S. economy during this period.

In 2002, \$70 billion of refinancing proceeds went to repay short-term "home-equity" loans and to pay off credit card debt. The trend has had a significant impact on high-interest credit card debt. The yearly growth rate of revolving debt (mostly credit cards) fell to 1.6% at the end of 2002, a 20-year low, after peaking at 12% in early 2001. (Also, see "Online Financial Services" below.)

## **6. Insurance Sells Well on the Internet**

According to Celent Communications, online insurance buyers represent 19% of

personal lines premiums. By 2005, the figure is expected to rise to 37%, or more than \$200 billion.

Like any other financial services-related industry, the insurance segment will continue to undergo major changes as e-commerce and the Internet affect it. The Internet and the development of e-commerce promise to deliver more expedient operations and cost efficiency to the insurance industry, though they also raise many new questions.

Insurers selling over the Internet have a substantial cost advantage over the lifetime of a customer, relative to non-Internet-based insurers. Reduced sales costs, lower customer service expenses and more advanced information-gathering capacities fuel efficiencies. Consequently, e-commerce has prompted many insurers to upgrade and integrate their information systems.

The roles of insurance intermediaries and agents and the overall structure of the insurance market are changing dramatically as a result of e-commerce influences. Several insurance portals now exist where consumers can generate a number of competing insurance quotes within seconds. Because providing information and writing transactions have been the primary functions of insurance agents, electronic markets that can perform these tasks more efficiently and with fewer costs threaten these agents. Several agent functions are currently being displaced. Today, there are approximately 1.8 million insurance agents in the U.S., taking an average commission of about 11% of insurance policy premiums. However, the number of agents will decline. According to the Center for Risk Management and Insurance Research at Georgia State University, the furthering of e-commerce will decrease the use of the independent agency system relative to exclusive agent and direct-response distribution systems that have grown rapidly since the 1970s. The future role of the insurance agent may be geared more toward customer service and advising than generating sales.

The concept that the network becomes more valuable as more people are connected to it is also affecting the insurance industry. Hundreds of millions of people on the Internet translate into an increase in the potential of Internet-based insurance services.

With the increased value of online connections come decreased distribution costs. For example, policies such as travel, credit or burial insurance have relatively high fixed costs and low value, but nonetheless have significant transaction costs. Consequently, customers purchasing these products generally pay a high price per dollar of coverage. The Internet allows the automation of the sales and underwriting process, meaning that prices can be lowered and more insurance can be sold by reducing transaction costs. Increased access through e-commerce is also influencing some consumers to purchase broader, high-value insurance products, such as liability umbrellas.

Meanwhile, the security of insurance customers' data online will be an important consideration, given the large amount of proprietary and highly personal information at stake.

The Internet and advanced corporate computer networks are prompting many insurers to restructure and repackage insurance services. In order to take advantage of advanced Internet technology, many companies are reengineering, outsourcing and/or streamlining their management functions or marketing and distribution arms. Some insurers will be able to reduce their investments in physical facilities and

certain personnel as a result of the Internet's ability to more efficiently deliver their services. For example, insurance giant Cigna Corp. eliminated 2,000 jobs at the beginning of 2002 as a result of changes in the way it services accounts.

The Internet and e-commerce change the way that customers interact with their insurers. Customers can obtain quick quotes from a number of companies and can see ratings and evaluations of insurers on the web. Additionally, they can receive better customer service and enjoy cost savings.

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