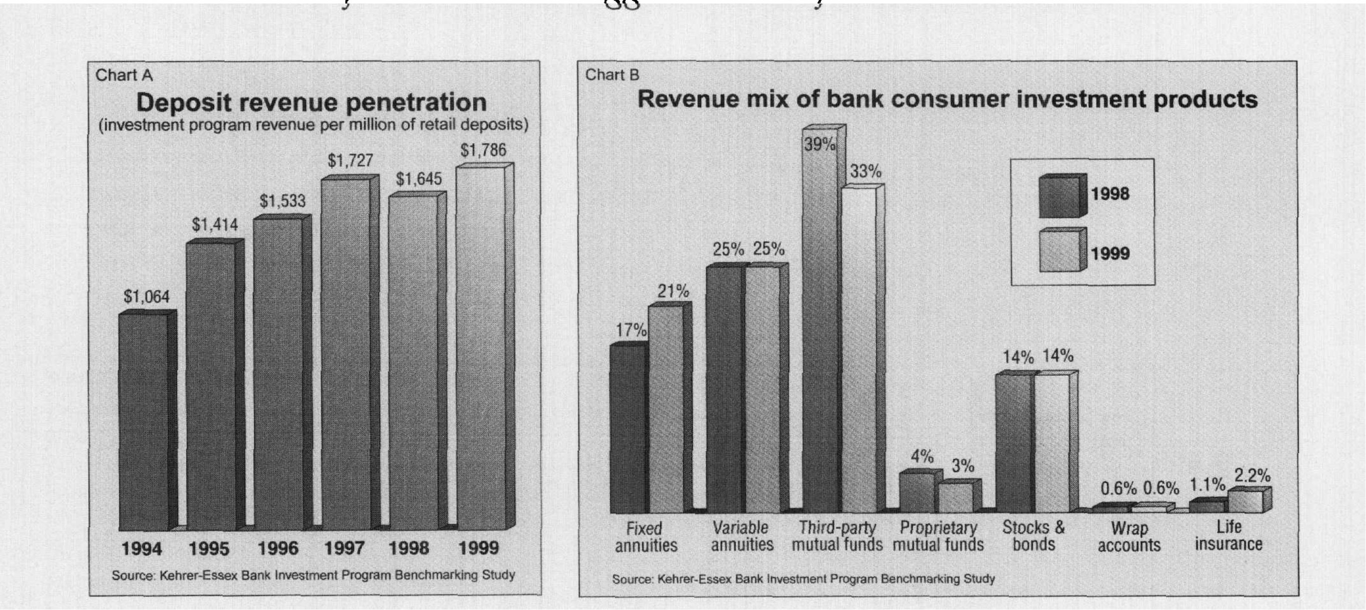
Investment services report card: Higher growth, lower profits

Research shows fixed annuities make a comeback. Branch referrals remain biggest source of investment sales leads



The bank investment services business had a banner year in 1999. Sales, gross revenue, and sales force productivity all increased in the typical bank retail investment sales program, according to the *2000 Consumer Investments Study* released last month by the Consumer Bankers Association. But declining profit margins constrained the contribution of the investment sales unit to the overall banking enterprise.

Sales of investment products—mutual funds and annuities—averaged 3.3% of a bank's retail deposits last year, up 14% from 1998 and 22% higher than the 2.7% sales penetration of deposits in 1997.

The typical bank consumer investment program had annual gross revenue of $1,786 per million in retail bank deposits in 1999, compared to $1,645 in 1998, a 9% improvement (Chart A). Revenue penetration of deposits measures revenue from mutual funds, annuities, and securities brokerage that the bank achieves, relative to the size of the retail bank.

*By **Kenneth Kehrer**, contributing editor and president of Kenneth Kehrer Associates, a Princeton, N.J., consulting company.*

Revenue mix

Fixed annuities accounted for 21% of bank consumer investment services revenue in 1999, up from 17% in 1998 (Chart B). Fixed annuities used to account for the lion's share of revenue, but slipped from 40% in 1995 to 25% in 1997 and 17% in 1998. Between 1995 and mid 1999, low interest rates and the flat yield curve made fixed annuities relatively unattractive to retail investors, who were becoming more attracted to the booming equity market. The growing popularity of mutual funds and then variable annuities coaxed conservative investors away from fixed annuities. Those that were leery of the stock market could earn higher nominal interest in short-term CDs. The investing environment changed with the stock market volatility during the last half of 1999 and a steepening yield curve, which combined to make fixed annuities a safe harbor for skittish investors.

Mutual fund sales were strong during the first half of 1999, but fell sharply in the second half. As a result, mutual fund revenue was down to 36% of total consumer investment revenue in 1999, compared to 43% in 1998. The share of third party mutual funds fell from 39% to 33%, while bank proprietary mutual funds also lost revenue share, falling one percentage point to 3%.

Variable annuities avoided the sales setbacks experienced by mutual funds, maintaining a 25% share of revenue in bank consumer investment programs during 1999. This might seem anomalous, since variable annuities are essentially a tax-advantaged way of investing in mutual funds. But over the past few years various guarantees have been added to variable annuities, making them more attractive to investors who are nervous about losing money in mutual funds but don't want to miss out altogether on the outsized returns posted by some funds. Features that guarantee an increase in the investment's value upon death or annuitization have allayed many investors' fears, and high interest paid in dollar cost averaging accounts have spurred many to act now, rather than wait.

The share of sales revenue attributable to individual stock and bond sales remained the same at 14%.

Life insurance, wrap accounts, and money market mutual funds each accounted for only a thin slice of consumer investment revenue. In spite of all the press about bank marketing of fee-based investment products, wrap accounts generated less than 1% of bank consumer investment services revenue, the same level as 1998. Money market mutual funds increased their share of total revenue from 1% to 1.7%, while the revenue share of life insurance doubled to 2.2%. While life insurance sales are showing signs of life in bank consumer investment programs, they remain a small contributor to program revenue.

Profit margins

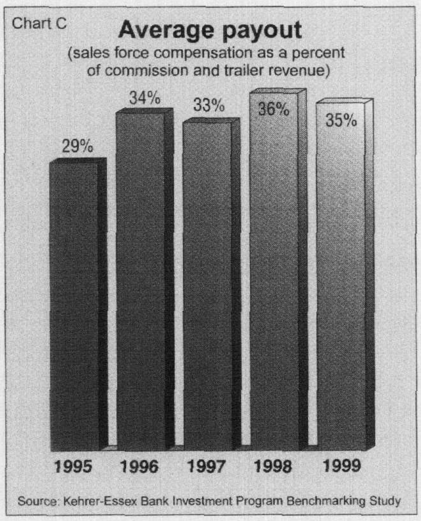
Bank consumer investment programs saw their profit margins shrink again during 1999. Net income (before corporate overhead allocation and taxes) in the typical bank program was 28% of revenue last year, down from 30% in 1998 and from the 32-33% level of 1996 and 1997. Average bank profit margin from consumer investment sales is now 8 to 10 percentage points below the level achieved in 1993 and 1994, when the typical bank program was bringing 36 to 38% of revenue to the bottom line.

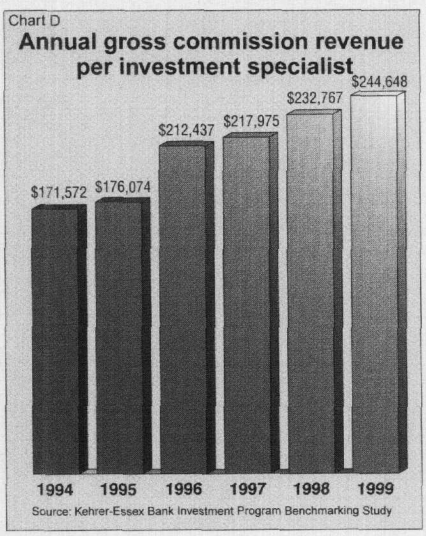
From 1995 to 1998 the decline in profit margins was largely the result of a shift from fixed annuities sales to mutual funds and general securities, because fixed annuity sales have much higher margins than mutual funds and individual stock and bond transactions. On the other hand, the growth in high margin variable annuity sales served to partially mitigate the squeeze on profit margins. In 1999 sales shifted back toward fixed annuities, but the growing popularity of "super-bonus" annuities — which reduce the sales commission and pay that amount in additional interest to the investor during the first-year—served to dilute the profitability of fixed annuity business.

While the decline in profit margins is cause for concern in the expense control environment of today's banking industry, bank consumer investment programs remain much more profitable than traditional retail securities firms. The profitability of the average retail brokerage firm, as reported by the Securities Industry Association, has ranged from 2% to 15% of revenue in recent years.

The reason why is that most banks appear to have focused on a very profitable component of the investment business—selling packaged investments like mutual funds and especially annuities to retail customers.

In addition, the profit margins of bank consumer investment programs have been built on a foundation of lower cost sales forces. Bank broker/dealers have been able to attract brokers at lower rates of compensation than traditional securities firms because of the promise of a steady flow of qualified referrals. Still, banks have increased payouts to their investment sales forces, from 29% in 1995 to 33-34% in 1996 and 1997, and 35-36% in 1998 and 1999 (Chart C). This trend line reflects bank efforts to keep brokers from leaving for nonbank securities firms, which tend to have payouts around 40%.





Broker productivity

Annual gross commission revenue produced per broker—the securities industry yardstick of broker productivity—was up for the fifth year in a row. The typical full-time Series 7 investment specialist working in a bank generated gross revenues of $244,648 during 1999, up 5% from 1998 and 43% above the 1994 level (Chart D).

While broker productivity continues to improve, the nature of the bank broker's sales are changing. The typical bank broker has been generating more "tickets" (investment transactions) every year. Although this trend abated in 1999, the typical bank broker still handled 62% more transactions during the year than in 1994.

The increase had been accompanied by a fall in the average ticket size (i.e., commission revenue per transaction). While this decline in ticket sizes appears to have leveled off in the past few years, the average transaction generated $416 in commission revenue in 1999, 41% less than 1994.

The main reason, again, is that fixed annuity sales fell. But another important reason stems from the success that banks have had recently in encouraging their brokers to obtain additional sales from existing investment customers, rather than relying on referrals from banking staff. Subsequent investments by the same customer tend to be smaller than the initial investment.

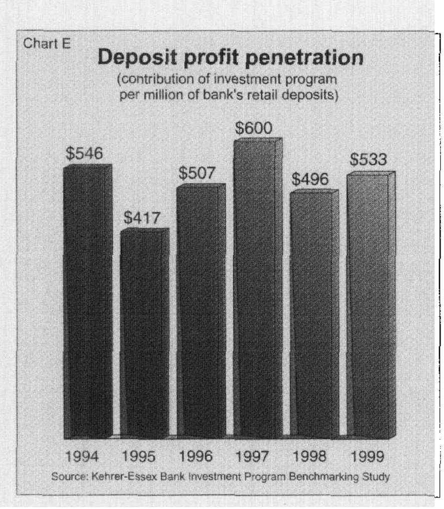
Other reasons are based on the changing nature of the broker's interaction with the customer. Some banks report that they have set up more systematic investment accounts for their customers, and these periodic, automated investments cannot be separated from the other investment sales in the bank sales reports. Of course, these systematic investments tend to be relatively small.

In addition, some bank consumer investment programs are now emphasizing an asset allocation approach to investing. This results in some investment sales being split into multiple tickets to diversify the investment. In those cases the average *reported* sale (i.e., ticket size) is much smaller than the *actual* sale. Average ticket sizes might continue to fall in banks because average tickets in bank consumer investment programs are still much larger than in traditional securities firms, where the average ticket size has been about $135 in recent years.

Productivity of branch bankers

More than half the banks in the study sold investments through platform bankers in addition to traditional brokers. (See *ABA BJ*, March 2000, p. 55 and April 2000, p. 65.) The productivity of licensed branch bankers fell 27% during 1999 to annual gross commission revenue of $10,737 per banker. The increase in the number of banks selling through licensed bankers tends to depress the average industry investment sales productivity of licensed bankers because the newly trained bankers are not as productive as the more experienced licensed bankers. Licensed banker productivity in banks that have been selling investments through bankers for over six years is typically twice the industry average.

For banks, regardless of how they distribute investments, deposit penetration is a better measure of profitability than revenue margin because it focuses on how much net income the bank's



investment sales program contributes relative to the size of the retail bank.

During 1999 higher sales revenue offset slimmer margins to pull the deposit profit penetration of bank consumer investment programs up 7%. Net income from consumer investments rose to $533 per million of retail deposits, but has generally been flat over the past few years (Chart E). The profit contribution of consumer investments in a typical bank remains 38% below the high water mark of 1993.

Marketing efforts increase.

As a general rule, banks have increased their investment-product marketing efforts in the past year. **Branch referrals continue to be the most popular method to identify investment prospects, used by virtually all banks, but seminars and systematic solicitation of existing investment customers are now used almost as universally as branch referrals.** More banks now use seminars and solicitation campaigns than did in 1999.

There were large increases in the number of banks that use direct mail and telemarketing to solicit consumer investment business of bank customers. While the prevalence of telemarketing just returned to prior year levels (about six out of ten banks), now seven out of every eight banks use direct mail marketing of consumer investment. More banks are also using advertising for retail investment services; three-fourths of the participating banks now have advertising programs, up from two-thirds last year and less than half in 1998.

The only marketing method in disfavor this year is branch merchandising, down for the third year in a row.

Banks generally report that branch referrals are the most important source of investment prospects. Systematic solicitation of investment customers is the next most important source, although fewer banks have ranked it to be that important in each of the past three years. In 1997, over two-thirds of the participating banks reported that database marketing was the second most important marketing method behind referrals, compared to only 43% this year. The next most valuable marketing methods now appear to be seminars and telemarketing. The perceived value of advertising has declined for several years, to the point where no banks rated advertising as the most important source of leads in 1998.

Banks have long sought to expand their investment sales to consumers who are not yet bank customers, but from 1995 to 1997 the typical bank consumer investment program reported that an increasing share of its consumer investment business came from existing customers of the bank. In 1998, the share of bank investment sales that came from noncustomers increased for the first time, from 26% to 43%.

This might reflect the acquisitions some banks have made of nonbank broker/dealers. In any case, the 1998 experience was not repeated last year, when only 30% of this business came from noncustomers. The bank consumer investment business is still fundamentally the business of meeting the investment needs of the bank's own customers. ***BJ***

About the Study

The Consumer Bankers Association's *Consumer Investments Study* was conducted by Kenneth Kehrer Associates in conjunction with the *Kehrer-Essex Corporation Bank Investment Program Benchmarking Study*. This year's study covered 466 financial institutions, which collectively account for 53% of all the bank consumer investment sales activity in the US. More information is available at *www.cbanet.org*.