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INTERFACE OF INSURANCE AND BANKING IN EUROPEAN COUNTRIES

By

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CITY UNIVERSITY, LONDON

The thesis submitted to the Department of Investment, Risk Management
& Insurance of City University Business School for the degree of
Doctor of Philosophy

2000

DECLARATION

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DEDICATION

To my mother and the memory of my father

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ABSTRACT

This thesis investigates one of the crucial issues currently facing the European financial institutions, in particular, banks and insurance companies. Currently in Europe, the banks are engaging into insurance business, and, the insurance companies, to a lesser effect, are engaging into banking business. These cross-business activities have broken down the long tradition of separation of these two financial industries, and have raised many questions. But there is little evidence on this issue, theoretically as well as empirically.

This thesis is a kind of interdisciplinary approach and it has two parts. In the first part, the thesis examines various interfaces that exist between the European banks and insurance companies from two perspectives: banks' perspective as well as insurance companies' perspective. (Chapter two and three respectively). Based on industrial economic theory, organisation theory, the strategy & international business theory, and the regulation theory, a historical analysis is employed for the examination of these various interfaces. The thesis also examines the traditional relationships and traditional distribution channels of banks as well as insurance companies and the development of their current changing patterns. Driving forces for these changing interfaces and the regulation concerning changes of interface are also considered in the thesis (Chapter four). The EC Directives on banking and insurance are also given their due weight for this examination. One of the major contributions in the first part is to make a theoretical development of this new area, and the creation of 'bancassurance' and 'assurancebank' data that is scarce and can be invaluable for further research and development on this issue. Some of these data are used in the second part of the thesis.

In the second part of the thesis, two sets of empirical tests are conducted. The first test is the test of return and risk effects on European bank holding companies diversification into various insurance business, namely life assurance underwriting, general insurance underwriting, and insurance broking business. The second test is opposite to the first one, i.e. the test of return and risk effects on European insurance holding companies diversification into banking business (Chapter five and six respectively). Based on finance literature, econometric work is employed for these tests. The results of the first test shows that banks significantly increase their risk in underwriting of life as well as underwriting of general insurance business. Expansion in life underwriting significantly increases returns but the effect on return from expanding in general insurance underwriting is not significant. The most profitable expansion is into insurance broking business since our results indicate a significant positive effect on return with no adverse effects on risk. On the other hand, the results of the second test shows that the insurance companies bankruptcy risk although increases, two other risk measurements indicate significant risk reduction, and the return in this case does not have significant effect. This suggests that only the cross-business distribution activities should be permitted and the cross-business underwriting activities should be restricted in order to reduce the probability of bankruptcies.

CHAPTER ONE

INTRODUCTION

1.1. INTRODUCTION

The research in this thesis deals with some of the most crucial issues currently facing the European insurance and the banking industries, the two most important players in the financial service world. Both play a key role in a country's economic system and their actions have public policy implications directly. That is why they are highly regulated and supervised. In the United Kingdom, the banking business is regulated and supervised under The Banking Act 1987, and the building societies under the Building Societies Act 1987. On the other hand, insurance business is regulated and supervised under The Insurance Companies Act 1982. In the case of Lloyds of London, The Lloyds Act 1984 is applied. Similarly, other European countries also regulate and supervise their banking and insurance industries through their national laws and regulations.

Although the banking and the insurance businesses have different legislation and regulation, they have a very close relationship. They are some times referred to as 'the two sides of the same coin' [Manwaring (1977)]. More recently, especially after the late eighties, we notice a dramatic change in the relationship between the European banking and insurance sector. This is due to the various regulatory changes, the World Trade Organisation's liberalisation of trade in services following the Uruguay Round, and the gradual arrival of the single European market in financial services [Hardwick (1997), Hardwick and Dou (1998)]. For these, banks are diversifying into insurance

business, and to a lesser degree, insurance companies are making inroads into the banking business although the banks are more aggressive than the insurance companies. For banks and insurance companies such convergence has created a new phenomenon in the financial services world. This is known as '*Bancassurance*', '*Assurancebank*' or '*Allfinanz*'¹.

Before the 'big bang' in 1986, the banking and the insurance business were considered in a more traditional way. They hardly introduced each other's products although Barclays is a notable exception. The regulators have traditionally kept them separate for a long time for the safety and soundness of these two industries. However, this is changing rapidly in European countries, especially in Western Europe. For instance, if we look back to an article in the Financial Times in 22nd January 1975 by Gilling-Smith regarding pension fund management, he showed that out of seventeen funds fourteen were managed by insurance companies, two by unit trusts companies, and only one by a bank². Today, almost all the banks manage pension funds through their pension fund management outlets.

On the other side, under the then Insurance Companies Act 1974 in the UK, the DTI (Department of Trade and Industry) was given power to call for the appointment of an approved trustee, as a custodian of certain assets, in the event of a new insurance company being formed, even as a subsidiary of an established company, or of a change of a ownership. By the end of 1975, that is within less than two years, the DTI is reported to have called for the appointment of trustees for about fifty companies.

¹ We will clarify these three technical terms later on in Chapter two and three.

² Keyser Ullman, a merchant banks.

Banks traditionally conducted these trustee businesses. Today, in the nineties, this trusteeship is treated as if they are insurance companies' traditional products.

But still in the rest of the world, including the US, Japan and other strong economies, these two industries are kept separate from each other. For instance, in the US the Glass-Steagal Act 1933 prohibits of such cross-business activities. Only exception is where there are no more than five thousands people in any US town. In these countries there is a burning question as to whether such cross-business activities should be allowed.

However, even though for banks and insurance companies such changing interfaces have become widespread only from the late eighties in Europe, such relationships have long been established, especially in the UK. This was found in Crick and Wadsworth [1936] and was later reported by Maycock and Ravel [1976]. In 1836, a firm of Scottish solicitors was responsible for the formation of both the North of Scotland Bank and the Northern Insurance Company. Through mergers and absorptions, they are now part of the Midland Bank and Commercial Union Assurance Company.

With the changes of time, the relationships among the services group are changing. Financial services are available twenty four hours a day. The electronic network has made possible that which was unthinkable two or three decades ago. These changing relationships can be drawn in three stages; up to mid seventies, from the mid-seventies to the early eighties, and from the late eighties onwards especially early nineties [Saint-Goers (1991)].

Until the mid seventies, banking, insurance and other financial markets could be understood in terms of a few basic activities. Enterprises managed their holdings in a simple way. The complexity began in the late seventies. In the eighties, we saw the introduction of different types of assets and liabilities management tools. Financial engineering then becomes the name of the game with standby communication among all the markets. The future and options became more than hedging instruments. The sophistication of instruments, the instant link arbitrage facilities and huge amounts of currency circulation among the markets has fundamentally changed both nature of risk and nature of the regulation.

If we look at the EC level, we notice that the deregulation of financial services and liberalisation of international trade in the services industries is a joint global strategy of the EEC [Secretary General of the CEA, Paris (1996)]. For mutual recognition among the member states and for the single license system three principles were made. These are mutual recognition, minimum harmonisation and home country control. The minimum harmonisation has abandoned the different traditions and legislation of the different European countries. After producing this harmonisation mutual recognition of authorisation and supervision in the head office country was set up at a European level standard. Once the minimum recognition and minimum harmonisation had been achieved, that led to a system known as 'single license'. Banks, insurance, investment companies are then subject to one and the same supervisory system as that of its home country, also known as 'home country control'. So, the authorisation granted to an establishment by its home country will be its 'European Passport' for other member countries under this umbrella to exercise its activities freely without further authorisation in countries other than its own. The new Community strategy based on these three principles is the guiding force behind the

implementation of the Internal Market in financial services: banking, insurance, and investment services.

The Second Banking Directive gave the power on a single license system and integrated head office supervision for the banks and the credit institutions. The Third Life and Non-Life Insurance Directives gave the same power to set up the same single license system in insurance. There are also Investment Directive, Accounting Standard Directive, and, lately, Pension Fund Directive. All these Directives are making closer link among the financial institutions-banking, insurance, investment, and securities.

The rest of this chapter is as follows: Section 2 outlines the motivation for undertaking this research; Section 3 determines the aims and objectives of this thesis and formulates hypotheses for empirical test; Section 4 outlines the methodologies to be used in this research and the sources of data; Section 5 define the terms ‘interface’, ‘banking’ and ‘insurance’ for this research; Section 6, describe the structural summary of the thesis; and Section 7, concludes the introduction.

1.2. MOTIVATION FOR THIS RESEARCH

The thesis was motivated by the following reasons:

1. The changing interface between the banks and insurance companies is a burning question to the financial services industry. But there is little evidence, theoretically as well as empirically, as to whether such cross-business strategic approach by banks and insurance companies is desirable or whether this will ultimately ruin the banking and insurance industries. Therefore, this is a very important as well as an interesting topic to be undertaken for research.

2. In the US, where the regulators deliberately prohibit such cross-business activities (The Glass-Steagal Act 1933), we find some hypothetical studies that are based on the US data. These studies are mixed and are not unambiguous. Whereas in the Europe, where such cross-business activities are permitted by the regulators, we find little evidence on this issue. What we have found here in Europe, especially in Western Europe, are some descriptive personal views or very few case studies in a very limited way³. We believe this research will fill at least part of the gap in the new field of literature.
3. Banks and insurance companies have begun their cross-business activities very recently due to the deregulation of financial markets and due to harmonisation of the financial business within the Member States of the EC. The concept of ‘bancassurance’, ‘assurancebank’ or ‘allfinanz’ is new. These words have not even been entered into the dictionary as yet. But this concept is currently an issue of intense concern in the financial services world. Therefore, it is worthy to undertake a research at least from academic purpose in order to gain an insight into this new area for its theoretical development.
4. The cross-business activities between the banks and the insurance companies are permitted only in the Europe. In the rest of the world, including other very strong economies such as the US, Japan, Canada etc, such cross business activities are prohibited by the regulators. There is a burning question in the rest of the financial markets of the world as to whether such cross business strategic approach for banks

³ In the UK Brown et al., [1996] conducted a study on the UK bancassurance but not on the assurancebank firms in return and risks context. Their study was based on hypothetical mergers and they considered only UK life assurance companies. They did not consider the general insurance underwriting, and insurance broking activities conducted by banks.

and insurance companies should be allowed in order to generate a better competitive market or whether such interfaces will ultimately ruin the total financial system. Even the European regulators, who have permitted banks and insurance companies to conduct cross-business activities, do not have any empirical evidence of the potential threat and future impact of this radical change. So, we believe that the regulators, bankers, as well as the insurers of these countries will find this research useful for their further decision making process regarding this new phenomenon.

5. Even in Europe, a significant number of banks and insurance companies have not adopted this strategy as yet, simply because of the lack of empirical evidence as to whether adoption of such strategy is beneficial or not for them to have a competitive gain and for survival in the market. This research will at least partly help them in further consideration of this issue.
6. Not only that, bankers and insurers those who have already adopted this cross business strategy still are not sure whether they are doing the right thing due to any empirical evidence. They will also find this useful for further decision making process.
7. This research is also important from the public policy perspective. As the banks and the insurance companies play key role for a country's economic system, and as the major banks and insurance companies in Europe have adopted this cross business strategy, it is essential to carry out research on this aspect as to whether

combination of these two risky industries increase the probability of their bankruptcy risk. If this happens, this will ruin the whole financial system by damaging individuals' paramount trust and faith of the banking and insurance sector, and a huge number of depositors and policyholders will lose their savings.

1.3. AIMS AND OBJECTIVES OF THIS THESIS

The general objectives of this research are to examine the various interfaces that exist between the banks and the insurance companies in the European countries, and to develop a theoretical framework of this new area of business. Another objective is to create data from the European context that is scarce and invaluable for further research and development. Finally, the thesis examines empirically whether such interfaces are desirable or ultimately whether they will lead to ruin of the financial system.

More specifically, the objective of this study is to investigate the strategic approach of cross business activities that have recently been adopted by the European banks and insurance companies, i.e. so called 'bancassurance' or 'assurancebank' strategy, and the implication of these strategies in terms of return and risks.

Banks have countrywide branch network. They have huge number of employees with a vast customer base. Banks believe they can use these special facilities for selling insurance. Once they are successful in insurance selling they then can move one step further, i.e. underwriting of insurance in addition to their day to day banking activities. Insurance companies also believe, in addition to their insurance activities they, by using their traditional agency and distribution network, can conduct banking activities. For banks and insurance companies such cross-section strategies raise many issues. Among the issues the most important issue is its future survival, i.e. the bankruptcy

risk. In other words, the risk effect of banks as well as insurance companies if they engage into each other's business.

Banking and insurance both are risky business. Both conduct their business with direct public moneys, the banks by taking money as deposits, and the insurance companies by taking money as premium, and thus, are highly regulated to safeguard the economy and to protect the public's savings. But little research has been done on what's the effects of amalgamation will be. Therefore, this is a crucial issue to be examined.

1.3.1. MAIN HYPOTHESES TO BE TESTED

We propose two hypotheses to test the implication of the adoption of banking and insurance company cross-business strategic approach in our econometric analysis.

Since diversification spread the risks and thus reduces risks, our first hypothesis is that

1. *The banks will decrease their risks and increase their return when banks engage into (i) life assurance underwriting, (ii) general insurance underwriting, and (iii) insurance broking businesses, compared to banks' stand alone basis; and,*

The second hypothesis is that

2. *The insurance companies will decrease their risks and increase their return when insurance companies engage into banking business, compared to insurance companies' stand- alone basis.* We call the first one as *bancassurance hypothesis* and, the second one as *assurancebank hypothesis*.

1.3.2. MAIN QUESTIONS TO BE ANSWERED

The main questions to be answered in this thesis are as follows: Should *banks be in insurance business? If so, in what sector, life sector or non-life as well? And, in what capacity as a distributor only or underwriter as well? Again, should insurance companies be in banking business? If so, in what sector, investment banking only or commercial banking as well?* To answer these questions we examine the interfaces from two viewpoints, one from the bankers' viewpoint and the other from the insurers' viewpoint. As the bankers are more aggressive than the insurers, we will place greater emphasis on the bankers' viewpoint.

To examine from the bankers' viewpoint we examine interfaces from four angles. These are:- Banks in life assurance distribution, Banks in life assurance underwriting, Banks in general insurance distribution; and, Banks in general insurance underwriting. On the other side, to examine from insurers' view point we examine interfaces from three angles. These are:- insurance companies in commercial banking, insurance companies in investment banking, and insurance companies in Tele banking.

The *development of the changing relationships* between the banks and the insurance companies in European countries, and the *driving forces* for these changes, and the changes of their *regulatory framework* are also considered in the thesis.

1.4. RESEARCH DESIGN, METHODOLOGY AND DATA COLLECTION

1.4.1. RESEARCH DESIGN

This thesis is a kind of interdisciplinary approach. It has two parts. In the first part, the thesis examines various interfaces that exist between the European banks and insurance companies from two perspectives: banks' perspective as well as insurance

companies' perspective (Chapter two and three respectively). Driving forces for these changing interfaces and the regulation concerning changes of interface are also considered in the thesis (Chapter four). The EC Directives on banking and insurance are also given their due weight for this examination. Based on industrial economic theory, organisation theory, strategy & international business theory, and the regulation theory, a historical analysis is employed for the examination of these various interfaces and for the theoretical development of 'bancassurance' and 'assurancebank'.

In the second part of the thesis, two sets of empirical tests are conducted. The first test is the test of return and risk effects on European bank holding companies' diversification into various forms of insurance business, namely life assurance underwriting, general insurance underwriting, and insurance broking business. The second test is opposite to the first one, i.e. the test of return and risk effects on European insurance holding companies' diversification into banking business. (Chapter five and six respectively). Based on finance literature, econometric work is employed for these tests. Finally, the main findings are summarised and some policy recommendations are made and suggest some of the issues for further research. (Chapter seven).

1.4.2. METHODOLOGY

To examine the main issues and test the hypotheses formulated above, we have adopted a number of methodologies that include, historical analysis, econometric analysis, personal interviews, as well as manual search from press clippings etc, and correspondence to European banks and insurance companies and their regulators. One

may argue about employing a number of different methodologies in one research. But since this research area is new, and since there is little evidence on this new area of business, both theoretically as well as empirically, we have had to approach these methods to be familiar with this new area of business, and to collect data for the theoretical development as well as for the empirical tests. [Kandampully (1993) and Decker (1997) employed similar approach in their Ph.D. research].

The *historical analysis* is employed in conceptional way for the theoretical development of various interfaces between banks and insurance companies. This theoretical development is based on industrial economic theory, organisation theory, strategy & international business theory, and the regulation theory. *Personal interviews* are conducted to bank branches randomly to obtain an overall idea of how the 'bancassurance' work at branch level. *Manual search and correspondence* are made to collect the data. This is based on press clippings, industry reports, journal articles, companies annual reports and accounts as well as correspondence with both industries and the regulators. Since there is no readily available data, collecting data, which is scarce and invaluable for further research and development, is one of the main contributions in this thesis. Some of these data will be used in our empirical analysis.

The *econometric work*, which is based on finance literature, is employed for our empirical analysis to test the proposed hypotheses formulated above to see the implications of these changing interfaces in terms of return and risk consideration. In the econometric work, we heavily rely on Boyd & Graham (1988) method, and Boyd, Graham & Hewitt (1993) method. We extend and develop these methods further, and

apply them to the European market. Details of methodological approaches are stated in each case before conducting our investigation.

1.4.3. DATA COLLECTION

Data is crucial in any kind of scientific research. The data can be original or secondary level. Whatever level the data may be, the main factors in considering data are (i) the availability of data, (ii) the sources of data, (iii) the validity of data and (iv) the accuracy of data. One of the main problems of this thesis is the unavailability of data either from commercial sources or other sources.

Banks and insurance companies' cross-business activities have begun only very recently. Moreover, they conduct their business mainly through separate subsidiaries. Therefore, they do not report their subsidiary companies' data in details. In other words these subsidiaries' data are off balance sheet data. In selecting sample as well as the data, the problem we face here is that we do not know which banks have diversified into insurance business and what they are, and, on the other hand, which insurance companies have diversified into banking business and what they are. Diacon (1990b) reported some of the UK bancassurance companies' data. They were of course helpful in extending the sample size.

When a research project is in the international context, availability of data is even scarcer. Much of our time was spent collecting data. Therefore, collecting data, which is scarce, can be invaluable for further research and development of this new area, and this could be one of our main contributions in the thesis.

In order to select our sample for the econometric work as well as for supporting the theoretical arguments, we have to find the data from the whole banking as well as whole insurance industries in the European context. To test our proposed hypotheses,

we have initially taken The Banker's (1994) top 100 European banks out of top five hundred European banks, and the top 100 insurance companies from the 'Top European 15000'.

For the bancassurance risk test (Hypothesis 1), the banks' sample has been collected from the FT EXTEL 1997, but to collect the banks' own insurance subsidiary data, we have faced a severe problem. To solve this problem, there is no other alternative available to us but to chose a manual search. We started manual search from press clippings, industry reports, companies' annual reports, different directories etc. in order to ascertain how many out of top 100 have adopted bancassurance strategy. We have found that all the banks have at least some sorts of direct involvement in insurance business.

We then started searching the banks' involvement in life assurance underwriting, general insurance underwriting, and insurance broking. Here we faced some problems. There are some banks who have 100% wholly owned insurance subsidiaries, while some have just 10% to 15% equity holding of underwriting insurance subsidiaries or even just a tied agreement/strategic alliance for joint sales. At this stage, we decided a criterion that we will take as our sample only the underwriting insurance subsidiaries of banks that have over 50% equity holdings. Fortunately, the entire insurance sample has over 90% equity holding of banks.

We have decided to take only banks' own insurance underwriting subsidiaries (life and/or general insurance), excluding those banks who just have a tied agreement/strategic alliance for joint sales of insurance. Because in a joint distribution

agreement, banks bear a very little risk⁴, and underwriting insurance companies bear the main risks since if claims arise underwriting companies will have to bear the claims, not the banks. If banks can sell insurance they will get commission/fees from the underwriting companies otherwise not. Therefore, the main risk ultimately falls in the insurance underwriters.

We have excluded strategic groups for insurance distribution, but we included banks that have wholly owned insurance broking subsidiaries to see the impact of banks involvement in insurance broking business.

One thing to note here that there are some banks within the top 100 lists which do not have any insurance underwriting subsidiaries. These banks have a tied relationships or strategic alliance agreement with traditional big insurers for insurance distribution. For instance, Dresdner Bank that is in 12th position by assets size have a strategic alliance with Allianz in Germany. On the other hand, we have found some in our manual search that there are some banks that are not in the top 100 list but have insurance underwriting subsidiaries. For example, Leeds Permanent Building society in the UK that has a life assurance underwriting subsidiary named Leeds Life. We have, therefore, included them in the sample and excluded the banks that have no underwriting or wholly owned insurance broking subsidiary in the top 100 list.

We have also found that some banks have more than one *life* insurance underwriting subsidiaries (TSB in the UK, Credit Lyonnais in France) in addition to general

⁴ For details please see universal banking in the United States, what could we win, what could we lose?, Walters & Saunders, (1994), Cambridge university Press, New York, 1994.

insurance underwriting subsidiaries and broking subsidiaries, while some have just one life underwriting or broking subsidiary. Anyway, we have included all.

However, after a long time consuming manual search we have found 58 life assurance underwriting subsidiaries, 18 general insurance underwriting subsidiaries, and 22 insurance broking subsidiaries⁵. This is reported in Appendix III. Most of the wholly owned insurance subsidiaries are domestic companies. Only two (Generali, and Bishopgate insurance) in our sample are cross-border mergers.

Now, the next stage is to collect the data of the above sample. At this stage, we also faced severe problem. Accounting data have been collected from the period of 1991-1996. Researchers always have to pay attention while collecting data, in particular the validity of data and the accuracy of data. Accounting data have been collected from the companies published annual reports and accounts. This is probably the most reliable source and is widely used in empirical analysis.

To get the accounting data, we first searched in the commercial sources like FT EXTEL, Data Stream etc, but we did not succeed. We then wrote to the individual European countries insurance regulators, specifying the names of the insurance companies. We had a very little success in this process. We then wrote to individual parent banks, specifying their insurance subsidiary name, to supply us these subsidiaries data. This time we have got some effective response after a second reminder letter.

⁵ Country profile and cross border proportion are reported in Appendices III.

But still these samples are not sufficient to run a valid statistical test. We then wrote to the banks' insurance subsidiaries directly. Here also after a second reminder letter we have got some positive reply. But still we fail to get some companies data. This is because probably they do not want to disclose their data outside.

In the final stage, we created a databank in spreadsheets from the annual accounts. This time we also face some potential problems. Our sample is international base sample. Therefore, different countries will have obviously different accounting system and different timing period of accounts. Moreover, different countries have different currency, and local companies produce accounts in local currency. We, therefore, can not combine all the different company's data together. To solve this problem, we converted the local currency data to the European Currency Unit (now Euro) year by year.

All the insurance subsidiary data are 31st of December in each final year in all the countries in our sample. Only in the UK two banks have 31st of March timing period data. We believe this should not bias our results. Though different countries may have different accounting system, our sample is within the EC countries⁶. The EC Directive has harmonised the accounting system within the member countries. Moreover, our variables are too broad [like total assets, total net income etc] to have a potential bias.

The UK life assurance companies, data have been collected from the DTI returns. We also face problem with the UK data. The UK life assurance companies have to submit their returns in a specific prescribed form, supplied by the DTI. The DTI forms do not indicate shareholders equity, and net income. We, therefore, have taken minimum required margin (form 9) as a proxy of shareholders equity. If a life assurance company become insolvent, this required minimum would be used as shareholders

⁶ We have included Switzerland in our sample. Though this country is not within the EC but it is treated as if it is a member of the EC in case of the financial services.

equity. Net income is calculated as total income minus total expenditure including taxation⁷.

There may be an argument in selecting accounting data verses economic data. Each has advantages and disadvantages. But there is not a totally satisfactory explanation as yet which data is most suitable for empirical analysis [e.g. Greenawalt and Sinkey (1988); Mehra and Prescott (1985); Franklin et al (1982)]. However, we did not have any choice in selecting data due to unavailability of economic data.

We have selected our banks sample if and only if a bank has at least any of the wholly owned insurance subsidiaries, i.e. either life assurance underwriting subsidiary or general insurance underwriting subsidiary or insurance broking subsidiary. 44 banks, 40 life assurance companies, 12 general insurance companies, and 11 insurance broking companies have been found by applying these criteria to our observations⁸. Details are discussed in Chapter five.

On the other hand, *for the assurancebank risk test (Hypothesis 2)*, we have initially taken top 100 European insurance companies from the 'Top European 15000'. Again, we do not know which insurance companies have engaged in banking business, and in which sector, i.e. investment banking or commercial banking business. We then started manual search as above and found some banks that are owned by insurance companies. These are reported in Chapter three. Since insurance companies began to engage into banking business very recently, i.e. from early and mid nineties, we can not get sufficient real data from them for a statistical analysis. We, therefore, adopt an

⁷ Brown et al., (1996) adopted similar proxy in their study of UK life companies return and risk characteristics.

alternative way for assurancebank companies. We conduct a simulation study for assurancebank for academic purpose. For the simulation study, the data is taken from FT EXTEL 1997. Details are discussed in Chapter six.

Further details of data sources, method, suitability, and validity are reported in chapters where they are used.

1.5. MEANING OF BANKING, INSURANCE, AND INTERFACE FOR THIS RESEARCH

1.5.i. Meaning of banking:

There is no universally acceptable definition of a bank or banking. Banking, though it is easy to understand is difficult to define. Even the regulators are unable to define it. In the UK the Banking Act 1987 it is just mentioned as 'doing banking business'. This act gives some characteristic of banking business stating 'those are authorised under this act to conduct business'. As this is a complicated matter, we will define 'bank,' for our research purpose, as those who takes deposits from the common public, lends money, and have a country wide branch network. This will include building societies, investment banks, tele banks and savings banks unless otherwise stated.

It is very difficult to define banks according to the products or nature of business. Bankers as well as insurers in Europe currently offer a variety of products, many of which are not of their origin. However, the core products of banks are:- (i) taking money as deposits from the public, (ii) lending of money, and (iii) money transmission services [Hanson (1987)]. Williams (1995) described five types of basic products function:- (i) providing media for customers' investment, i.e. offering customers

⁸ The sample size decreases because we dropped out some samples due to the lack of availability of data for the whole sample period.

instruments for investment that provide an opportunity for customers to increase their capital; (ii) safe keeping; (iii) transaction execution, i.e. facilitating transfers of customers' funds to third parties; (iv) providing management, advice, and information concerning financial assets; and (v) extenuation of bank resources to third parties for commercial or investment purposes, e.g. making loans, guarantees, letters of credit, and acquiring obligations of their customers. There are different types of banks specialising in different banking activities. The most common are commercial banks; savings banks; investment banks; co-operative bank; postal bank and, foreign banks; other banks.

1.5.ii. Meaning of 'insurance':

As for banks, there is no legal definition of insurance. The Insurance Companies Acts or the EC Directives do not define insurance. They just mention 'doing insurance business' or 'undertaking insurance business'. Different authors define insurance in different ways. Some says it is 'a risk transfer mechanism'. Others, with special regard to the legal sense it is defined as a 'contract'. Insurance may be defined as a 'system science' where by individual risks are gathered and then spread in a scientific way over the sample taken, i.e. by using the law of large numbers. The core products of insurance are taking risks (risk transfer) against loss through making common pools and by charging equitable premiums [Dickson (1992)].

Insurance companies are classified in variety of ways. These are according to ownership structure, according to the nature of business, and according to the structure of business. According to ownership structure, insurance companies are classified as proprietary company, mutual company, and captive company. According to the nature

of business, they are classified as Life Assurance Company, general insurance company, Reinsurance Company, and industrial assurance company. According to structure of business, insurance companies are classified as composite insurance company, specialist insurance company, and the Lloyds of London⁹. For our research purpose, we will classify insurance companies into the life assurance companies and the general insurance companies, unless otherwise stated.

1.5.iii. Meaning of ‘interface’:

Interface is a term, which describes how two things interact or link [Collins English Dictionary (1991)]. Maycock & Revel [1976] described banking insurance interface in three dimensions as:- competitive, non-competitive and, administrative interface. Dickinson & Dinenis (1992) described banking insurance interface from the economic angle. They mentioned interface as:- supply- consumer relationships, agency role, and competitive poster. Interface does not only mean interdependencies, as commonly regarded, but also inter-competition and inter-co-operation as well. Therefore, this study will expressly or implicitly divide the interface into three broad categories as:

- *Banking-insurance interdependencies;*
- *Banking-insurance competitive interface; and*
- *Banking-insurance co-operative interface.*

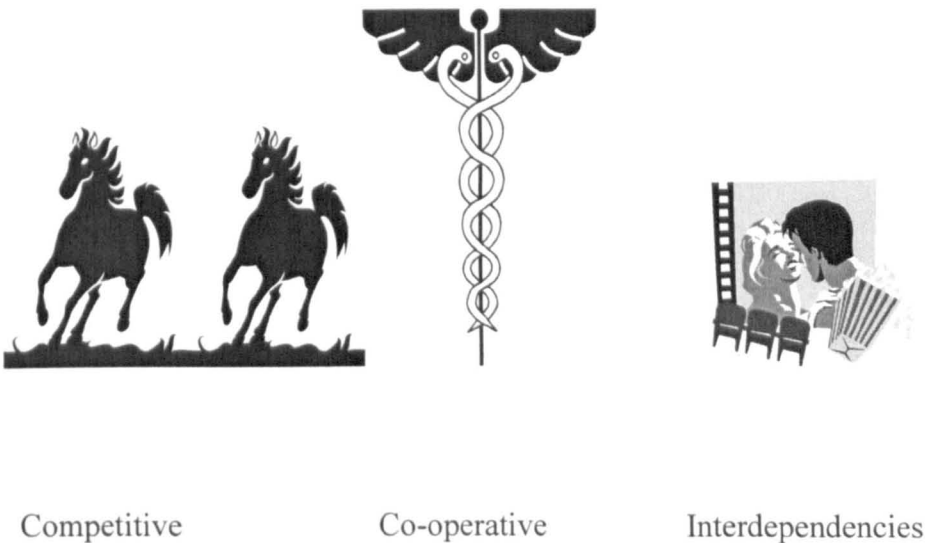
When banks and insurance companies are dependent on each other for conducting their businesses, we describe these as interdependencies. In economic terms, we may describe a supply-consumer relationship. On the other hand, when banks invade insurer territory or *vice versa*, we describe it is a competitive interface. Banks can

⁹ This is a special type of insurance marketplace that only exists in the UK.

acquire or establish their own insurance company as a manufacturer as well as a distributor of insurance products. Insurance companies, on the other hand, may establish banking firm and, by producing and distributing banking products can compete with traditional bankers directly.

Co-operative interface is when banks and insurance companies co-operate with each other for both of their mutual business benefit. For instance, a bank may co-operate with an insurer, by selling that insurance companies insurance products through the banks branch network with the banking products line in exchange for commissions and fees and, on the other hand, a insurance company may co-operate with banks for selling that bank's banking products, (loan, mortgage etc) through its traditional channel of insurance distribution with insurance products line. In this way, both can increase their products selling and, thus can mutual benefit. The commercial interfaces between banks and insurance companies as to whether they are competitive or co-operative will be examined later. In the following, in figure 1.1, we have drawn a picture of various interfaces between banking and insurance.

Figure: 1.1. Interface of Insurance and Banking



1.6. CONCLUSION

This introduction chapter briefly outlines the rationale of this research. The importance of this research is discussed in motivation section and the aims and objectives are then determined for this research. Then the specific hypotheses are proposed to be tested, and the main questions are determined here to be answered. After deciding the aims and objectives, brief methodological approaches and data collection are described. Finally, the terms ‘banking’ ‘insurance’ and ‘interface’ are defined for this research purpose. In the next two chapters, we will examine the recent development in banking and recent development in insurance industries respectively.

CHAPTER TWO

RECENT DEVELOPMENTS IN THE EUROPEAN BANKING

2.1. INTRODUCTION

The purpose of this chapter is to critically examine recent developments in the European banking industry, particularly the phenomenon of *bancassurance*. To this end, we first review the European banking market place and then review the recent development in banking. We then investigate the various interfaces between the banks and insurance companies from the banks' viewpoint in order to develop a theoretical framework for the new phenomenon of 'bancassurance' as well as to create data sample for empirical analysis.

The rest of this chapter is as follows: in Section 2, the European banking market place is outlined in order to provide a general view of the European banking market place. Section 3 reviews the recent development in European banking. Section 4 defines the term 'bancassurance'. Section 5 investigates the various interfaces from the banker's viewpoint in order to provide the theoretical development of 'bancassurance' and to create data for the proposed hypotheses. Finally in Section 6, the conclusions of the chapter are drawn.

2.2. THE EUROPEAN BANKING MARKET PLACE

Europe is the third largest banking market in the world after North America and Asia (including Japan). In 1994, there were 2603 banks with 95960 branches and 1124658 employees in the EU countries. The total assets of European commercial banks were 6727.1 Euro billions. The UK and France account for nearly 50% of total assets. The breakdown statistics of the EU banking industry are shown country by country in Table 2.1 in order to overview the banking industry i.e. number of banks, branches, employees, and assets of the individual countries and their share in the EU.

Table: 2.1
Overview of European commercial banks, 1994

Country	No. Of Banks	No. of Branches	No. of employees	Total Assets (bn Euro)	European share by assets(%)
Belgium	147	7791	76270	594.8	8.84
Denmark	120	2245	44685	126.2	1.87
Germany	331	7571	219200	858.2	12.75
Greece	40	1637	42985	51.8	0.77
Spain	165	17469	150624	460.9	6.85
France	427	10428	201209	1193.5	17.73
Ireland	56	1002	22400	63.8	0.95
Italy	315	20580	328167	1015.4	15.09
Luxembourg	222	315	17638	449.7	6.68
Netherlands	173	6648	105963	655.1	9.74
Austria	56	732	16732	111.3	1.65
Portugal	46	3378	61649	132.6	1.97
Finland	15	911	24556	86.7	1.28
Sweden	17	2329	39498	151.1	2.25
UK	484	12400	367700	1989.5	29.57
EURO Total	2603	95960	1124658	6727.1	100%

Source: ECBF/Panorama '96

2.3. RECENT DEVELOPMENT IN BANKING

There have been a number of changes in recent banking activities, especially in Europe. It is now widely accepted that the traditional 'current account' is no longer a profitable business. The common market theme, which was introduced in the Treaty of Rome (1957), has created heavy competition in the European financial markets. The First, Second and the Third Banking Directives have given a single licence to banks to conduct businesses within the Member Countries. Furthermore, allowing building societies and mortgage companies (For instance, the UK Building Societies Act 1988) to diversify into banking business has created a further threat for European banks. At the same time, customer habits are changing. People want everything from under one roof including banking products, securities products as well as insurance and investment products. Technology has been dramatically improved, especially after the seventies. Information can be sent more efficiently and faster than ever before. Laptop, mobile telephone, Internet, and modern telephone system have made it easier to transfer messages. The risk management tools have also been improved. Sophisticated high tech has allowed financial companies to assess risks efficiently and thus minimise risks¹. In addition to the traditional option and futures markets, more complex derivative instruments have been introduced in the financial markets. Trade and business have become more internationalised by the day. All these have forced banks to diversify into different areas of business to ensure their profitability, growth and competitive market position. Some of the major diversified areas of banks and building societies are reported in Table 2.2.

Table: 2.2
Banks and Building Societies major diversified products

	Clearing Banks	Building Societies
Payment Services	Yes	Yes
Consumer Loans	Yes	Yes
Business Loans	Yes	Yes
Life Assurance: manufacture	Yes	Yes
Life Assurance: distribution	Yes	Yes
General Insurance: manufacture	Yes	Yes
General Insurance: distribution	Yes	Yes
Estate Agency/Property Services	Yes	Yes
Fund Management via unit trusts (mutual funds)	Yes	Yes
Personal Pensions	Yes	Yes
Credit Cards	Yes	Yes
Independent Financial Advice	Yes	Yes
Mortgages	Yes	Yes
Securities Market-making	Yes	N/a
Securities Broking	Yes	Yes
Securities Underwriting	Yes	N/a
Investment Banking Services	Yes	N/a
Factoring	Yes	Yes
Leasing	Yes	Yes
Derivatives Trading	Yes	N/a

N/a = not available. Source: Derived from Llewellyn (1994) and own compilation

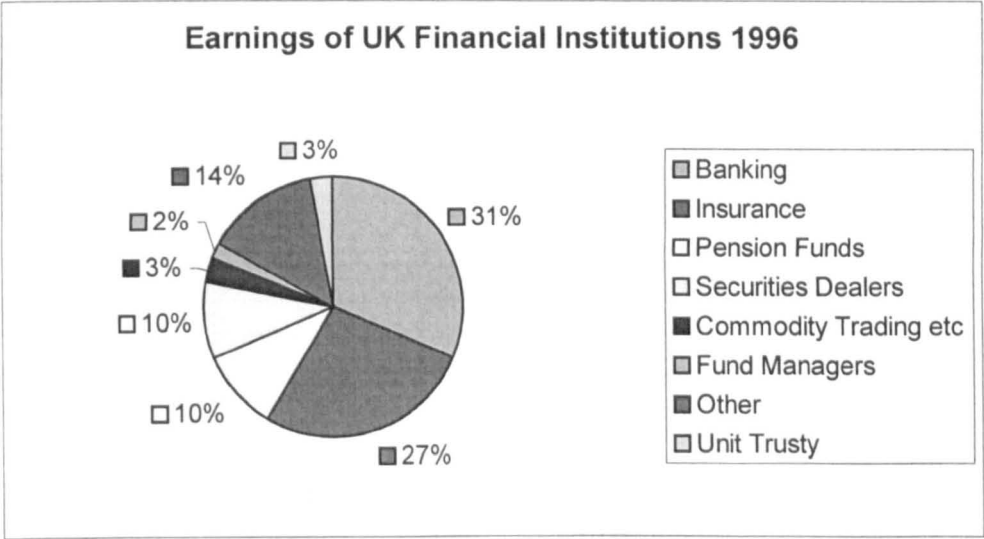
From Table 2.2, it is seen that European banks have diversified into a wider financial business area. From the chart (enclosed in appendix II), it is also seen that Credit Swiss, one of the largest European banks, has diversified into different non-bank financial services. Other big banks, like Credit Swiss, have also diversified into different non-bank financial services in Europe.

Among the financial institutions, banks, investment banks, securities firms, insurance and pension fund companies are the major provider of financial services. From the graph below (Graph 2.1), it is seen that banking, insurance and pension account for two third of financial institutions earnings. The banks account for 31% and insurance

For instance, cards transactions and the introduction of PDQ terminal.

companies for 27% of total earnings in the UK. It is believed that other European countries have a more or less similar situation. We, therefore, concentrate on these three² financial institutions' cross-business activities that cover nearly 70% of the total financial market in the EU.

Graph: 2.1



Source: ABI 1998

However, a number of researchers have already conducted research on bank diversification into different non-bank financial activities. For instance, Rajan (1994), Puri (1994), Gande et al., (1994), James and Wier (1990), Gardener (1990b), Brewer et al., (1988), Goodhart (1987), Giddy (1985), Edwards (1981) have examined the diversification of banks into securities.

Similarly, Steinherr (1995), Walter and Smith (1993), and Benston (1990) have studied the impact of diversification into investment banking activities. The majority of the studies support the diversification activities in terms of return, risks and cost

² In the EU countries, pension businesses are provided mainly by the insurance companies, therefore, we will broadly concentrate on two i.e. banks verses insurance companies' cross-diversification only.

efficiencies (Discussed further in Chapter five and six.). The historical data also support the benefit of bank diversification. For instance, from Table 2.3, it is seen that the EU banks, by providing non-bank financial services account for significant amount of earnings as a means of fees and commission.

Table: 2.3
Fees and Commission Receivable by Banks, 1996

	Local currency (m)
Austria	33887
Belgium	71632
Denmark	8361
France	102548
Germany	31294
Greece	230186
Ireland	800
Italy	10690 (bn)
Portugal	118467
Spain	832 (bn)
Sweden	14547
Switzerland	15407
United Kingdom	12325

Source: Derived from the OECD 1998

But, there is little evidence on the banks' diversification into insurance activities i.e. *bancassurance* activities, especially in a European context. Due to the lack of theoretical as well as empirical evidence, we will only concentrate on bank diversification into different insurance activities to fill up some of the gaps in the literature.

2.4. BANCASSURANCE - A NEW PHENOMENON

The word '*bancassurance*' is not yet defined in a dictionary. This is a French word and currently is being widely used in the financial services. '*Bancassurance*' is a term where insurance products are sold through a bank countrywide branch networks to its existing client base. Some definitions of bancassurance are given below.

Sigma, (02/1992) defined bancassurance as a strategy adopted by banks or insurance companies aiming to operate in the financial services market in a more or less integrated manner. Hielkema (1994) defined bancassurance as, 'a marketing strategy aimed at increasing sales for a bank or an insurance company by selling the product of the one through the distribution channels of the other, whereby the benefits also can be extended to various forms of cost sharing.' Leach (1996) defined 'bancassurance as insurance sales made by insurance companies in which banks have an equal or controlling stake of the equity.' Coopers and Lybrand (1993) mentioned bancassurance as 'strategies adopted by banks or insurance companies aiming to operate in the personal sector of financial services market in a more or less integrated manner'. In the view of Morgan (1994), 'bancassurance refers to a financial institution with a branch network, which in addition to its money transmission and lending services also sells its own insurance and investment products to its branch customers'.

Papasawas & Prame (1992) defined 'bancassurance' as the provision of insurance and banking products or services through a common distribution channel or to a common client base. The word 'provision' embraces both manufacturer and distributor of the products or services.

All the authors, mentioned above, define '*bancassurance*' when banks engage into insurance business or insurance companies engage into banking business. We strongly disagree with this. When banks engage in insurance business we call it bancassurance, and when insurance companies engage in banking business we call it assurancebank rather than bancassurance. In other words, bancassurance is a situation when financial holding companies major activities are banking business rather than insurance

business, and assurancebank is a situation where financial holding companies major activities are insurance business rather than banking business.

Some writers defined 'bancassurance' and '*allfinanz*' as having the same meaning. But there is a significant difference between '*bancassurance*' and '*allfinanz*'. The '*Allfinanz*' is a German word, which includes securities business in addition to banking and insurance. Farny (1990) defined allfinanz in Germany as concerning the integration of the following set of activities in banking and insurance: (a.) Production, (b.) Distribution, (c.) Marketing, (d.) Consumer demand, and (e.) Consumption.

Wager [1990] defined allfinanz as an integration or combination of the supply of services from three groups of financial organisations, namely: (i.) commercial banks, savings bank, and credit institutions, (ii.) Building societies, (iii.) Life and non-life insurance. These three terms, i.e. bancassurance, assurancebank and allfinanz, are discussed further in chapter three.

2.5. ENTRY STRATEGIES INTO BANCASSURANCE

Banks use various entry strategies in order to engage in insurance business. The OECD (1992) study mentioned the following entry strategies: (i.) complete integration; (ii.) bank parent- non-bank subsidiaries; (iii.) bank's participation in non-bank affiliates; (iv.) holding company; (v.) joint venture; and (vi.) sales & marketing agreement. Walter and Saunders (1994) identified three ways for banks to diversify into insurance business. These are: (i.) in house via a department of the group; (ii.) via a separately capitalised subsidiary; and (iii.) via a separately capitalised affiliate of the holding company. Kane (1995) described the banks' entry into insurance in slightly different ways such as: (i.) forming an insurance-agency subsidiary at a bank or bank holding company; (ii.) forming a bank subsidiary at an insurance or insurance-agency

firm; (iii.) negotiating a participating lease agreement, a joint employee or marketing program, or a joint venture contract between a bank and an insurance agency or underwriter. Hoschka (1994) discussed all the entry process in four categories. These are:- (i.) de novo entry; (ii.) mergers and/or acquisitions; (iii.) joint ventures; and (iv.) distribution alliance. Papasavvas and Parmee (1992) mentioned five ways of entry into bancassurance. These are- (i.) Opening the client base of one party to the distribution channels of the other; (ii.) General agency agreements, i.e. in the UK banks and building societies acting as IFA; (iii.) Tied agency agreements, i.e. in the UK the bank and building societies acting as an 'Appointed Representative'; (iv.) Ownership of one party by the other, or both parties owned by the same company or group; and (v.) Joint ventures.

However, according to the level of integration and the degree of riskiness, all the entry strategies are classified into five groups. These are (i.) start-up approach; (ii.) mergers and acquisitions; (iii.) creation of a holding company; (iv.) joint venture; and (v.) strategic alliance.

Some writers give mergers and acquisitions and strategic alliance, or strategic alliance and joint venture the same meaning in their research. But as far as the risks factor are concerned in bancassurance, which is one of the main objectives in this research, these entry strategies are fundamentally different from each other. We, therefore, discuss all of these entry strategies in order to clarify the level of integration and risks.

(i.) Start-up Approach:

The start-up approach (some times referred to as 'de novo entry') is one of the most important entry tools used by the banks in order to enter into insurance activities. In

this approach banks set up their own insurance subsidiary from scratch. All the rights and responsibilities of such a new venture then belong to the parent bank.

The choice of this entry strategy has merits and demerits. As a start up approach into new areas of business, the key demerits are the difficulty of getting the team expertise and adjusting the two separate management bodies and more capital (compared to strategic alliance or joint venture) is required here. Further more, to learn the 'know how' of business and to get the benefits from this type of entry is lengthy, and a lot of advertisements and time is required for its publicity in order to build up a client base. However, the banks have already a client base in their banking area, which may be a prospective client base for insurance products too. But some customer may not be interested in doing business with such a new unknown insurance company or may not wish to put 'all his eggs in one basket'. Empirical results show that such strategy takes at least nine years to become a profitable enterprise [De Young and Hasan (1997)]. Rose and Savage (1984) found that the de novo banks had riskier assets, incurred higher operating expenses. Huyser (1986) found that the failure of de novo banks were more likely than established banks.

The good side of this entry is that a bank can build up a subsidiary according to its own choice and need, and keep match with its banking products. Hoschka (1994) suggested this type of entry strategy for bancassurance companies. The Barclays, the largest UK bank, has adopted this strategy. It has set up its own life assurance company, the Barclays Life Assurance Company, in 1965. This life insurance subsidiary is used as workshop of life and pension products, and marketed by the Barclays bank branch network. Some other big banks in the UK and in Europe have also adopted the same strategy. For example, the TSB, the fifth largest UK bank, has set up its own life and non-life as well as insurance broking subsidiaries. These are the

TSB Life Ltd, the TSB General Insurance Ltd, and the TSB General insurance services Ltd. In France, the Credit Agricole, the country's largest and Europe's number one bank has set up its own life and non-life insurance companies named the Predica and the Pacifica respectively. Predica is now the third largest life assurance company in France. The Deutsche Bank, Germany's largest and one of top five European banks, has set up its own life assurance company, the DB Leben. The DB Leben, later on in 1994, has merged with Deutsche Harold, a general insurance subsidiary.

ii. Mergers and/or Acquisitions:

This is another important entry strategy where banks merge with another insurer or acquire an existing insurance company. As mentioned earlier, some researchers believe mergers and acquisitions are the same as strategic alliance, which contradicts our assumptions with respect to risk effects. Therefore, for this research the merger is defined as a technique where two or more companies combining in such a way that remains, after the event, only one company, which is the universal successor to the former companies. All the rights and all the liabilities of these companies continue as rights and liabilities of the successor company. Sealy (1993) mentioned take-over as 'a technique for effecting a merger or amalgamation between the businesses of two or more companies. There may be two ways of doing this. One is cross-section and the other is cross-border. After the take over, the two companies remain in being but the Offeree Company becomes a subsidiary company of the other and controlled and monitored by the acquiring company. Vander Venet (1996) found that domestic *mergers* among equal-sized partners significantly increase the performance of the

merged banks. Improvement of cost efficiency was also found in cross-boarder *acquisitions*.

In the UK, the Lloyds bank, the fourth largest commercial bank in the country, has adopted this entry strategy. It has acquired the Abbey Life, which is now the tenth largest UK life assurance company in terms of premium income. The Banco Central Hispano of Spain has acquired the Generali of Italy through this entry strategy. Similarly, the Rabobank in the Netherlands has also adopted this strategy to acquire the Interpolis.

iii. Joint Venture:

This is also an important entry strategy. Harrigan (1988) defined joint venture as 'business agreements where two or more owners create a separate entity'. In this strategy, one bank and one insurance company set up a new insurance company, which is jointly own by them. This may be on a fifty-fifty share holding basis or fifty one forty nine-share bases. The balance of ownership will depend on the strengths of each company and their respective contributions to the new joint venture company. But the insurance companies are likely to be minority shareholders as banks have the upperhand through its ownership of the strong distribution channel. The parent insurance company provides technical support such as underwriting and sales training administration and investment management services while the parent bank provides support of distribution through its countrywide branch network to its banking client base. For example, the Credit Commercial de France (CCF) and the Elysees Sante have created a joint venture insurance company, the ERISA, where the CCF and Elysees both hold 50% equity each. McConnell and Nantell (1985) found significant wealth gain from *joint ventures*.

iv. Equity Holding:

While in equity holding banks (or insurance companies in *assurancebank* strategy) do not generally involve themselves in operating business activities directly, they rather simply acquire equity from insurance companies and receive dividends as a shareholder. But some companies acquire a significant share of the equity of insurance companies and use their bank branches for distribution of insurance. For instance, the Bank of Scotland has 34% of equity holding of the Standard life.

In the case of the formation of holding companies, a common management body is set up for the holding company to see the overall affairs of the entire holding with separate management for banking and insurance. ING has adopted this type of entry strategy. In a *holding company merger* analysis, Cornett and Tehranian (1992) found that the profitability improved significantly after the merger while in a study by Pilloff (1996) it was found that the mergers were not associated with any significant change in performance.

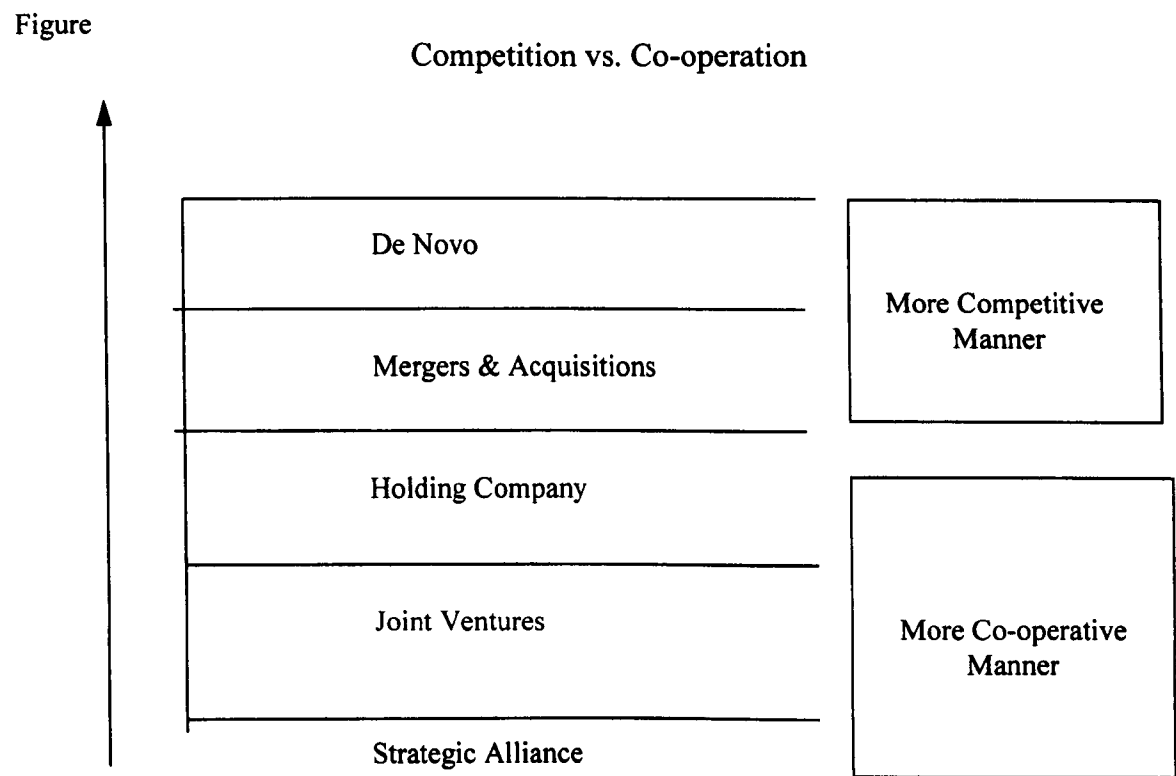
v. Strategic Alliance:

A strategic alliance is a long-term business agreement between two or more companies to pool exchange and/or integrate specified company resources for achieving some agreed objectives [Hung (1992)]. Dawson and Shaw (1992) described alliance as ‘co-operation between two or more retail companies whereby each partner seeks to add to its competencies by combining some resources with those of its partners.’ Sheth and Parvatiyar (1992) described alliance such that ‘an alliance is an on going formal business relationship between two or more independent organisations to achieve common goals.’ In case of bancassurance, a bank makes a

strategic alliance with an established insurance company to conduct joint sales of business in return for fees or commissions. Through such a strategic alliance, the banks sell insurance products with its banking products to its existing banking customers, and on the other hand, the insurance companies sell banking products with its insurance products to its existing insurance customer base. But they do not bear the underwriting risks for such cross-business distribution activities. In Germany, Dresdner Bank, the country's second largest bank, has such a strategic alliance with the country's largest insurer, Allianz, for joint sales of business. Chan et al., (1997) found significant positive wealth effects on non-equity *strategic alliance* and no evidence of wealth transfers between partners. These results support the conjecture in Jensen and Meckling (1991) that strategic alliances provide a cost effective way to place decision-making authority in the hands of individuals who possess the knowledge to make the best decisions.

From the entry strategies discussed above, we can see that the banks' risks vary according to the choice of entry mode. In the de novo entry, mergers and acquisitions and formation of holding company, the banks bear all the risks (and benefits) as they own the whole company through these entry form. On the other hand, in the strategic alliance and the joint ventures entry, the banks bear lower risks since they share risks (benefit) with the insurance companies. The strategic alliance has even lower risks than the joint venture strategy because the strategic alliance bears distribution risks only, whereas in the joint venture strategy the banks, in addition to bearing distribution risks, share underwriting risks with the insurance companies.

Figure: 2.1. Entry Strategies and Level of Integration



From Figure 2.1, it is seen that at the bottom the strategic alliance indicates the least risky (co-operative interface) entry mode, and at the top, the de novo (competitive interface) indicates the most risky entry mode while the holding form indicates some neutral position. Therefore, it is seen that the choice of entry strategy has a strong impact on diversification risk. For our empirical tests, we excluded strategic alliance as well as joint venture companies since banks have relatively lower risks in these types of relationships.

As there is little evidence of the effect of each of these entry strategies from a bancassurance perspective, it is, therefore, crucial to test these entry strategies

separately in order to assess the impact of these entry strategies. However, due to the limitation of the scope of this thesis and the time constraint, we will not investigate the entry strategies any further.

2.6. THE FIELD STUDY ON THE EUROPEAN BANCASSURANCE

For our investigation, we initially took the top 100 European banks (Appendix I) published by the Bankers (September, 94). We then searched through press clippings, industry reports, company annual reports, different directory etc. in order to discover how many of the top 100 banks are involved in insurance business. We have found that the majority of the banks have at least some direct involvement in insurance operation. The results of the banks' involvement in insurance business are reported in Table 2.4.

Table: 2.4
Major European banks direct involvement in insurance activities

	Major European Banks	Country	Life Assurance		General Insurance	
			Broking	Underwriting	Broking	Underwriting
1	Abbey National (24)	UK	Yes	Yes	Yes	No
2	Barclays Bank (8)	UK	Yes	Yes	Yes	No
3	NatWest Bank (11)	UK	Yes	Yes	Yes	No
4	Lloyds Bank (25)	UK	Yes	Yes	Yes	Yes
5	Midland Bank (3)*	UK	Yes	Yes	Yes	Yes
6	TSB Groups (67)	UK	Yes	Yes	Yes	Yes
7	RBS (55)	UK	Yes	Yes	Yes	Yes
8	Bank of Scotland (68)	UK	Yes	Yes	Yes	No
9	Standard Chartered Bank (65)	UK	No	No	No	No
10	SG Warburg (78)	UK	Yes	Yes	Yes	No
11	Leeds Permanent B.S.	UK	Yes	No	Yes	No
12	Co-operative Bank	UK	Yes	No	Yes	No
13	Halifax	UK	Yes	Yes	Yes	No
14	Nationwide	UK	Yes	Yes	Yes	No
15	Woolwich	UK	Yes	Yes	Yes	No
16	Banque Bruxells Lambart (46)	Belgium	Yes	Yes	Yes	Yes
17	Credit Communal de Belgium (37)	Belgium	Yes	No	Yes	No
18	Generale Bank (28)	Belgium	Yes	Yes	Yes	Yes
19	Kreditbank (48)	Belgium	Yes	Yes	Yes	Yes
20	CERA (92)	Belgium	Na**	Na	Na	Na
21	ASLK-CGER (53)	Belgium	Yes	Yes	Yes	No
22	Credit Agricole (4)	France	Yes	Yes	Yes	Yes
23	Credit Lyonnais (1)	France	Yes	Yes	Yes	Yes

24	Banque National de Paris (7)	France	Yes	Yes	Yes	No
25	Societe Generale (5)	France	Yes	Yes	Yes	Yes
26	Credit Commercial de France (56)	France	Yes	Yes	Yes	Yes
27	Credit Populaire (42)	France	Yes	Yes	Yes	Yes
28	Groupe Paribas (10)	France	Yes	No	Yes	No
29	Groupe Indosuez (49)	France	Yes	Yes	Yes	No
30	Cassie Depargna (17)	France	Na	Na	Na	Na
31	CIC (35)	France	Na	Na	Na	Na
32	CLF (51)	France	Na	Na	Na	Na
33	Credit National (91)	France	Na	Na	Na	Na
34	Deutsch Bank (2)	Germany***	Yes	Yes	Yes	Yes
35	Commerzbank (16)	Germany	Yes	No	Yes	No
36	Dresdner Bank (12)	Germany	Yes	No	Yes	No
37	DG Bank (23)	Germany	Yes	Na	Yes	Na
38	Banca de Roma (32)	Italy	Yes	No	Yes	No
39	San Paolo	Italy	Yes	Yes	Yes	Yes
40	Banca Commerciale Italiana (39)	Italy	Yes	Na	Yes	Na
41	CARIPLO (33)	Italy	Yes	Yes	Yes	Yes
42	Banca Nazionale del Lavoro (30)	Italy	Yes	Yes	Yes	Yes
43	IMI (69)	Italy	Yes	Yes	Yes	No
44	Monte de Paschi (36)	Italy	Yes	Yes	Yes	Yes
45	Banco de Napoli (43)	Italy	Na	Na	Na	Na
46	Credito Italiano (47)	Italy	Yes	Yes	Yes	No
47	Banco di Sicilia (74)	Italy	Na	Na	Na	Na
48	BPM (99)	Italy	Na	Na	Na	Na
49	BPN ((97)	Italy	Na	Na	Na	Na
50	BAV (90)	Italy	Na	Na	Na	Na
51	ABN-AMRO (6)	Nethland	Yes	Yes	Yes	No
52	ING Group (27)	Nethland	Yes	Yes	Yes	Yes
53	Rabobank (22)	Nethland	Yes	Yes	Yes	Yes
54	BNG (66)	Nethland	Na	Na	Na	Na
55	Banca Argentario (40)	Spain	Yes	Yes	Yes	Yes
56	BBV (38)	Spain	Yes	Yes	Yes	Yes
57	BCH (31)	Spain	Yes	Yes	Yes	Yes
58	Banco Santander (44)	Spain	Yes	Yes	Yes	Yes
59	Caja de Madrid (84)	Spain	Yes	Yes	Yes	Yes
60	Caja de Ahorros (54)	Spain	Yes	Yes	Yes	Yes
61	Credit Suisse (9)	Switzerland	Yes	Yes	Yes	No
62	Union Bank of Switzerland (13)	Switzerland	Yes	Yes	Yes	No
63	Swiss Bank Corporation (2)	Switzerland	Yes	No	Yes	No
64	S Handelsbanken (64)	Denmark	Yes	Yes	Yes	No
65	Banque Commercial de Portugees	Portugees	Yes	Yes	Yes	Yes
66	Swedbank (52)	Sweden	Yes	No	Yes	No
67	S-E Banken (57)	Sweden	Yes	No	Yes	No
68	Nordbanken (61)	Sweden	Na	Na	Na	Na

- HSBC; ** not available; ***.In Germany banks have mainly strategic alliance for distribution instead of underwriting. Market position of the big banks in Europe is shown in brackets ().

Source: own compilation

From Table 2.4, it is seen that the major European banks are engaged in insurance businesses both as an underwriter and as a distributor in life as well as in non-life

business. But the above results do not provide any evidence as to which European banks have diversified into which insurance businesses and what they are. Therefore, we need further investigation in order to create our data sample for econometric analysis. We, therefore, went into an in depth investigation amongst the banks which engage in insurance business in order to find out which category they fall into. We investigated these banks from four angles in the light of classification and activities.

These are-

1. Banks diversification into life assurance distribution activities;
2. Banks diversification into life assurance underwriting activities;
3. Banks diversification into general³ insurance distribution activities; and,
4. Banks diversification into general insurance underwriting activities.

At this stage it is seen that some banks (from our initial sample) have just tied relationships with the traditional insurance companies. On the other hand, some banks have life assurance underwriting subsidiary, general insurance underwriting subsidiary as well as wholly owned broking subsidiary. Some banks even have more than one life-underwriting subsidiary, like Credit Lyonnais in France and the TSB in the UK. We exclude all the 'tied insurance' companies' from the sample but include all those are owned by banks.

One thing to note here that there are some banks not in the top 100 list which do have insurance underwriting subsidiaries while some big banks in the top 100 do not have any insurance underwriting subsidiary. For instance, the Dresdner Bank in Germany has tied relationship with the Allianz for joint distribution. We have excluded from

the list those banks that do not have any insurance underwriting subsidiary or wholly owned broking subsidiary. And we have included those who have insurance underwriting subsidiary though they are not in our top 100 list. The results are reported in the appendix III.

2.6.1 BANKS DIVERSIFICATION INTO LIFE ASSURANCE DISTRIBUTION

Commercial banks can set up their own life assurance subsidiaries through a De novo entry or by mergers and acquisitions or as a joint venture basis with traditional insurers. Or they can simply tie up with one or more traditional life insurer in a strategic alliance [Hoschka (1994); OECD (1992); Saunder & Walter (1994)]. Banks also can set up insurance broking companies with a PLC status in addition to their own life assurance company which can act as Independent Financial Advisers [IFA] supplying the various products of different traditional insurance companies according to customers need and requirements.

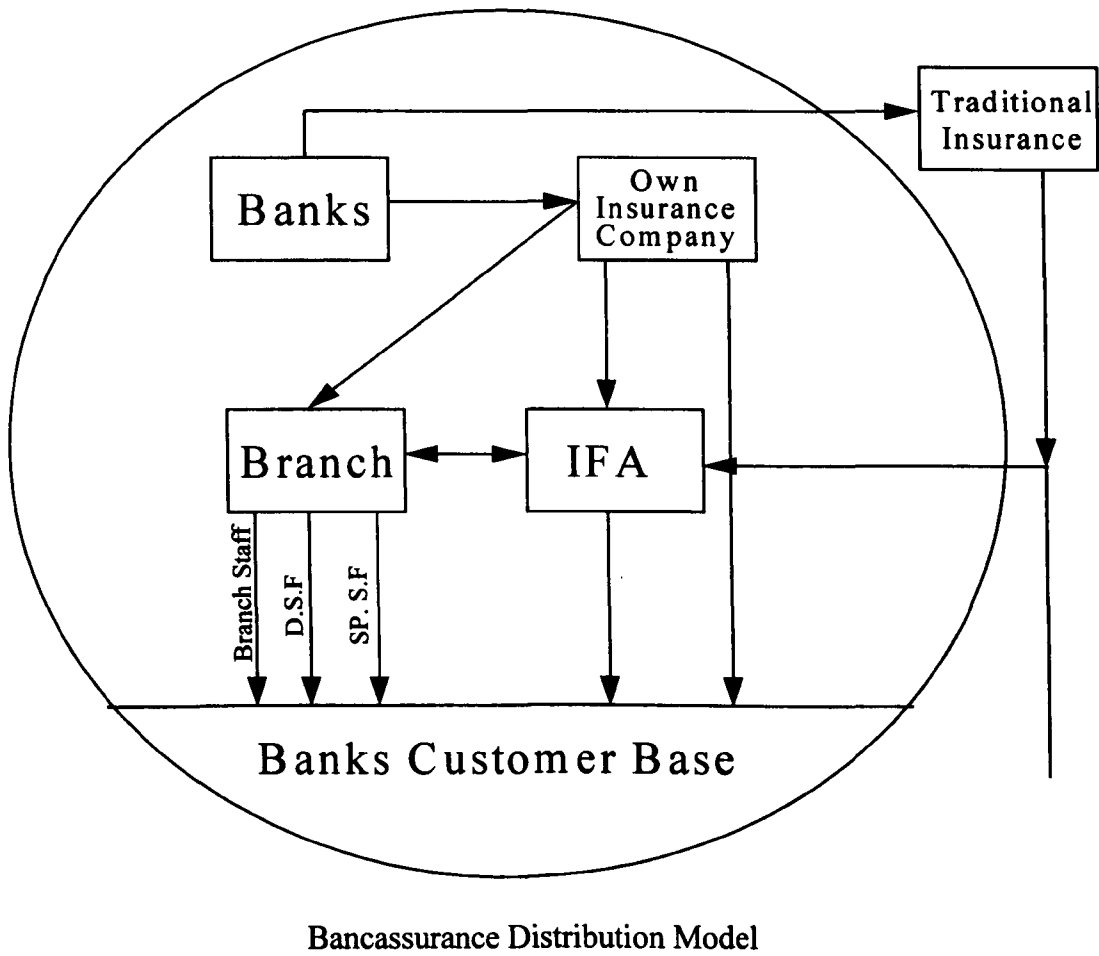
2.6.1.1. MODELING OF BANCASSURANCE DISTRIBUTION

This section is based on personal interviews with the branch staff of the banks as well as some previous case studies. For the interviews, which were conducted during October to November in 1995, six different commercial bank branches were chosen in the Greater London Area in order to understand how the bancassurance works at bank branch level. In our interview, we found that there are mainly three channels in the branch network: (i) Branch staff; (ii) Specialist Sales Force; and (iii) Direct Sales Force. In addition to these, there are also two other channels of life assurance

³ In the UK and most of the Europe short term insurance is known as general insurance while in the US

distribution which the banks use. These two are (iv). Independent Financial Adviser [IFA], and (v.) Direct Marketing. We now analyse how these channels work in the process of bancassurance.

Figure: 2.2. Bancassurance distribution model



(i.) Branch Staff:

In bank branches, there are branch staffs who conduct day to day banking activities to meet the customers' needs. These branch staffs are trained to sell life assurance at least at a basic level. In legal term, they can act as the agent of banks' own life assurance companies or as the agent of a company with which the bank has a link for insurance distribution. In the case of long-term insurance distribution process, branch staffs do

this is known as Property and Casualty Insurance.

mainly three tasks: (a) create a special database for identifying potential life insurance customer from the bank accounts. They consider various factors in creating such a database, such as age, occupation, income etc; (b) pass these data bases to the banks insurance sales force as ‘warm leads’ or, make links between the sales force and the potential customer; and (c) sell simple life insurance, if this is allowed, or just pass the customer to sales personnel. Individual branches have certain quotas for insurance selling to be filled up by that branch. These branch staffs continuously make links with the other channels within the parent banking group and co-ordinate the bancassurance process.

(ii.) Specialist Sales Force:

Banks sometimes employ specialist sales forces, especially for complex long-term insurance selling. These specialist sales force posses special insurance knowledge and expertise, and are employed either from amongst branch staffs or from outside. Such specialists are allocated two to three branches each. They give comprehensive advice to the customers and perform selling if possible. Some of the banks' specialist sales forces are shown in Table 2.5. A specialist sales force makes appointment at a mutual time and place, mostly at the branch, after referral by branch staffs, or branch staff may make the appointment on their behalf.

Table: 2.5

Some bancassurance specialist Sales Force 1994	
Bancassurance companies	Specialist Sales Force
Abbey Life	260
Barclays Life	182
Black Horse Life	163
Midland Life	123
Natwest Life	200

Source: Mintel '96

(iii.) Direct Sales Force:

The Direct Sales Force (DSF) is other channel of life insurance distribution. They mainly work from home but have strong links with the allocated branch from where they can acquire prospective customer or potential customer information by referral by branch staff. The banks' own insurance arm i.e. own life insurance companies mainly employs these DSFs. These sales forces cover those customers who do not frequently visit the branch with whom they try to make contact at the customer's home. Some of the banks' DSF is shown in Table 2.6.

Table: 2.6

The DSF for bancassurance companies, 1997

	Direct Sales Force
Abbey National Life	2500
Alliance & Leicester Life	200
Barclays Life	877
Black Horse Life	1400
Britannia Life	200
Halifax Life	725
National Australia Life	500
NatWest Life	1100
Midland Life	1500
Nationwide Life	336
Royal Scottish Assurance	220
TSB Life/Pension	1300
Woolwich Life	380

Source: Cazalet & Co 1998

(iv.) Direct Marketing:

Direct Marketing is a marketing process where products are distributed directly from the manufacturer to the consumers without any intermediaries. Though this has long been established in non-financial companies, the financial services companies such as banks and insurance companies have taken on this marketing strategy quite recently. Banks and insurance products are complex in nature. They are invisible as well.

Therefore, it is very difficult to market these products without face-to-face discussion. However, banks and insurance companies in Europe have begun to adopt this strategy due to technological improvement, thus to cutting at the middleman cost. In Europe, the UK first started this strategy which then began in other European countries. In the UK, the Direct Line, a motor insurance company, started this method in 1984 and has shown great success in the motor insurance market. For instance, the total expense ratio of Direct Line is 13% to 18%, while the industry ratio is 37% to 40%. Similarly, the First Direct, a Tele banking company started this method in 1988 for distributing banking products. This Tele banking is open 24 hours a day and 365 days a year, thus, the customers can do banking any time without visiting the bank branch. Some of the direct marketing companies of banks are shown in Table 2.7.

Table: 2.7

Banks Direct Marketing (DM) companies

<i>Bank</i>	<i>Country</i>	<i>Direct Marketing Arms</i>	<i>Entry</i>
Abbey National	UK	Abbey National Direct	1989
Alliance & Leicester	UK	A & L Personal Finance Ltd.	1989
Barclays	UK	Barclay Call Barclay loan Direct	1995 1993
Britannia Building Society	UK	Care Line Britannia Mortgage Direct	1994 1994
Cheltham & Gloucester	UK	Mortgage Direct	1994
Clydesdale Bank	UK	Clydesdale Telebank	1994
Co-operative Bank	UK	Coop-Armchair Banking	1993
Bank of Scotland	UK	Direct Line	1993
Midland Bank	UK	First Direct	1988
Halifax Building Society	UK	Halifax Direct	1995
Lloyds Bank	UK	Lloyds Line	1995
National & Provincial B. S.	UK	N & P Direct	1991
Nationwide Building Society	UK	Nationwide Direct	1995
NatWest Bank	UK	NatWest Prime Line	1991
TSB Group	UK	TSB Phone Bank	1994
Woolwich Building Society	UK	Woolwich Direct	1994
Deutsche Bank	Germany	Bank 24	1995
Groupe Paribas	France	Banque Direct	1994
Commerzbank	Germany	Comdirect	1995
Banco Santander	Spain	Genesis	1995
Banca Commercial de Portugueses	Portugal	Ocidental	1994
Bank of Ireland	Ireland	Premier Direct	1994

Source: Own Compilation from various sources.

v. IFA Channel:

The IFA (Independent Financial Adviser) is a traditional insurance distribution channel. Although the main purpose of the banks involvement in insurance business was to maximise the use of the bank branch network in order to minimise unit costs, the banks use the IFA channel in a similar manner to the traditional insurance companies, which may increase banks unit costs. A bank sets up an insurance broking subsidiary that has separate legal identity (shown in Table 2.11 in section 2.6.3 of this chapter). These broking companies, like other traditional insurance broking companies, gather different insurance underwriting companies' various insurance products. They, in addition to these products, gather their parent banks' underwriting (life and non-life both) insurance companies (if any) products and make sales. The special advantage of these broking companies' is that they have a very close link with their parent banks. If any bank customer inquires for independent insurance advice in the branch, he/she is then referred to that broking subsidiary or, in some cases, branch staff can do the job on their behalf. As major banking products are related to insurance products (discussed in Chapter four), these broking companies receive the majority of businesses from their parent banks. Before establishing these banks' broking subsidiaries, these insurance businesses were conducted by the traditional insurance intermediaries.

Some times these IFAs are provided with all the customer data from their respective parent banks and they then select a database for specific customers and select products according to the gender, age, profession etc. of the customers. From the selective database they then post application forms stating premium, cover, benefits etc. to the customer directly or via banks marketing department. If any one is interested they then

just sign and post it by the pre-paid envelope to the bank's own IFA broker directly. Such products are designed such a simple way that no advice is required for them.

One thing to mention here is that in the UK, after the implementation of the Financial Services Act 1986, any one who wants to engage into long-term insurance business must follow either of two following routes. One is called 'Independent Financial Adviser' (IFA), and the other is called 'Tied Agent'. The former is a person or a body corporate who can give advice and sell insurance on behalf of more than one, but maximum of six, insurance companies. They offer different types of products to the common client base and select according to which best suits the clients on a commission or fee basis. Tied Agent, on the other hand, is a person or body who can give advice and sell insurance on behalf of only one insurance company's products.

All the banks insurance broking subsidiaries enjoy the IFA status, and the branch staffs, the DSFs, and the SSFs have the tied status. Banks are mainly tied with their own/controlling life insurance companies or in case of non-existing own life companies they make strategic alliance with traditional insurance companies for a joint sale. Most of the banks have their own life assurance subsidiaries as well as insurance broking subsidiaries. Therefore a bank can enjoy 'tied status' through their own life insurance companies and at the same time 'IFA status' through their own insurance broking firm. Such a technical loophole gives banks the opportunity to enjoy tied status as well as independent status which is beyond the regulatory control until new regulations come into force. For instance, a customer can take insurance advice from the bank counter as tied today, while tomorrow the same counter staff can become independent to the same customer.

From the above analysis, it is seen that the banks use all the available channels in distributing life assurance. In order to compare the bank success in life assurance distribution, we show the ratio of premium income of bancassurance channel with the traditional channels (Table 2.8). This premium variable is chosen because the insurance companies main source of income is premium income, thus their survival or death mainly depends on this premium income. Most of these premium incomes are invested in order to have an another income to meet future claims and thus to enable companies to make a profit.

In 1995, the life market share by channel of distribution were as follows: the banks in France 56%, Germany 15%, Italy 19%, Spain 35%, and the Netherlands 15% (Sigma 1996). These figures and Table 2.8 show that the European banks have a significant market share in life assurance distribution. The French banks have more than half of the country's life assurance distribution market share. Spanish banks have 35% of total market share. This is a serious threat to traditional distributors like agents, brokers etc.

Table: 2.8
Individual life and pension distribution in European market, 1994
(% of New premium income)

Country	Brokers/M ulti tied	Tied Agents	Banks	Company Employees	Direct	Total
Belgium	57	9	19	15	0	100
France	7	13	55	20	5	100
Germany	30	61	7	2	0	100
Italy	11	43	20	26	0	100
Netherlands	45	7	18	14	16	100
Spain	12	48	23	16	1	100
Sweden	26	2	22	40	10	100
Switzerland	9	2	1	87	1	100
UK	39	7	15	36	2	100

Note: Figures do not necessarily add up to 100, due to rounding up and down decimal places.
Source: Financial Times and others

From Table 2.9, it is seen that a number of banks life companies are within the top five domestic league table, which indicates that the life companies owned by the banks are growing rapidly.

Table: 2.9
Some European bancassurance companies domestic market position, 1993

	Bancassurance Co	Parent Bank	Country	Life Premium (local currency million)	Domestic market share (%)	Position in top 5 in the Country
1	Alpha Life	Generale Bank	Belgium	1775	1.27	2 nd
2	Omniver Vie	Kreditbank	Belgium	1395	1.00	3 rd
3	Vida Caixa	La Caixa	Spain	65971	6.43	1 st
4	Euroseguros	BBV	Spain	106388	3.77	2 nd
5	Predica	Credit Agricole	France	30405	9.16	2 nd
6	Irish Life	Allied Ir. Bank	Ireland	572	32.06	1 st
7	Life Time	Anglo Ir. Bank	Ireland	130	7.28	3 rd
8	Fideuram Vita	IMI	Italy	620	14.10	2 nd
9	Mottepaschi Vida	Montedeipschi	Italy	521	3.10	4 th
10	Interpolis	Rabobank	Netherlands	1183	4.63	5 th
11	Ocidental Vida	BCP	Portugal	19746	11.92	1 st
12	Scottish Widow	RBS	UK	1600	2.88	4 th

Source: From Eurostate (1995) and various sources

2.6.2. BANKS DIVERSIFICATION INTO LIFE ASSURANCE UNDERWRITING

In our investigation, on the banks' life assurance underwriting activities, we have found that most of the European big commercial banks are engaged in life assurance underwriting business. We have found in our investigation that 74 life assurance companies are owned/controlled by banks⁴ (Appendix III). However, due to the lack of available data, we have reported data on 52 banks' life assurance underwriting subsidiaries with their premium income in Table 2.10. This sample data of life

⁴ There might be more. But we did not search all the banks as well as all the European countries. Our basis of investigation was within top 100 European banks. But we have added more that we found somewhere else.

assurance underwriting companies will be used for our empirical analysis in *Chapter five*.

Table: 2.10
Banks' own life assurance underwriting companies 1995

	Life Subsidiaries	Parent Banks	Country	Premium Income (local currencies)
1	Abbey Life	Lloyds Bank	UK	871282
2	Abbey National Life	Abbey National	UK	327276
3	Ambassador Life	TSB	UK	3960
4	Barclays Life	Barclays Group	UK	313760
5	Barclays Pension	Barclays Group	UK	505738
6	Black Horse Life	Lloyds Bank	UK	555397
7	Britannia Life	Britannia B. S.	UK	323877
7	First National Life	First National Fin. Corp.	UK	3826
9	Fleming Life	Robert Fleming	UK	80
10	Gisborne Life	Robert Fleming	UK	43000
11	Halifax Life	Halifax PLC	UK	56080
12	Hambro Assured	Hambros	UK	45382
13	Hamilton Life	HFC Bank	UK	21802
14	Hill Samuel Life	Hill Samuel Bank	UK	94142
15	Leeds Life	Leeds Permanent B.S	UK	6075
16	Midland Life	Midland Bank	UK	345591
17	N & P Life	N & P B.S.	UK	29052
18	Natwest Life	Natwest Bank	UK	167035
19	Royal Scott Assuranc	RBS	UK	130446
20	TSB Life	TSB	UK	429835
21	TSB Pension	TSB	UK	164960
22	Woolwich Life	Woolwich PLC	UK	88654
23	Predica	Credit Agricole	France	51261451601,61
24	Assurances Federales	Credit Lynnoise	France	16410537
25	UAF	Credit Lynnoise	France	16.45bn*
26	Sogicap	Societe Generale	France	14414604107,00
27	La Henin Vie	Group Indosuez	France	3751989971
28	ERISA Vie	CCF	France	4.1bn
29	Euroseguros	BBV	Spain	109064653
30	Vidacaixa	La Caixa	Spain	117879528
31	Cenit	Banco Santander	Spain	6908088
32	Caja de Madrid Vida	Caja de Madrid	Spain	4528096
33	La Estrella	Central Hispano	Spain	56000 m 94
34	Postal Vida	Caja de Madrid	Spain	9239757
35	BBL Life	BBL	Belgium	2499
36	Alpha Life	Banque Generale	Belgium	6705
37	Omniver Vie	Kreditbank	Belgium	6246
38	BNL Vita	BNL	Italy	398096671,187
39	Montepaschi Vita	Monte de Paschi	Italy	752009
40	Sanpaolo Vita	Sanpaolo	Italy	363529
41	Cari Vita	Caripaolo	Italy	419083
42	Fideuram Vita	IMI	Italy	1211267
43	CS Life	Credit Swiss	Switzerland	817165
44	Ocidental Vida	BCP	Portugal	44661
45	Interpolis	Rabo Bank	Netherlands	3398 (million)
46	Handel Sbanken Liv	Handel Sbanken	Sweden	1158275

Source: own compilation

It should be noted here that no bank, in our investigation in the EU countries, is allowed to underwrite long-term (life) assurance directly. They have to underwrite life assurance

business, if they so wish, via separate life assurance companies. These companies may be the banks' own or controlling life assurance subsidiaries or a joint venture with a traditional insurer. Banks underwrite mainly simple long-term products, so the underwriting process is also very simple for them. Normally banks do not require any medical examination or medical reports. Necessary information data are already available to life underwriters from the customer accounts at bank branch and based on these informations, i.e. age, occupation etc, underwriters can assess the risk and can set premiums. All the life assurance underwriters consider three factors in underwriting process. These are (i.) mortality; (ii.) investment; and (iii.) loading i.e. expenses. We are not going to analyse bank insurance underwriting in detail as it is same as the traditional life assurance underwriting process. From the underwriting workshop, products come to the bank's marketing department and its IFA broking companies. From there products are distributed to branches and customers (see Figure 2.2).

2.6.3. BANKS DIVERSIFICATION INTO GENERAL INSURANCE DISTRIBUTION

The European banks have distributed general insurance for a number of years. Therefore, in our investigation, we have found a number of insurance broking subsidiaries owned by banks. We have reported banks' wholly owned insurance broking subsidiaries in appendix III. However, we have reported here (Table 2.11) only those companies whose data we managed to acquire. These broking companies gather various insurance products [both life (discussed earlier) as well as non-life insurance products] from various traditional insurers as a distribution agreement and sell them via banks or their own sales forces. After the implementation of the

Financial Services Act 1986 in the UK, these brokers can not be tied to more than six traditional insurers.

Table: 2.11
Banks own general insurance distribution companies 1996

Broking Company	Bank Holding Company	Country	Premium income
Barclays Insurance Services Ltd.	Barclays	UK	107618
National Westminster Insurance Services Ltd.	NatWest Group	UK	114796
Lloyds Bank Insurance Services Ltd.	Lloyds Bank	UK	150363
Midland Bank Insurance Services Ltd.	Midland	UK	
RBS Insurance Services Ltd.	Royal Bank of Scotland	UK	11822
Bank of Scotland Insurance Consultant Ltd.	Bank of Scotland	UK	19.437*
TSB Insurance Services Ltd.	TSB Group	UK	
Halifax Mortgage Services (Insu. Brokers) Ltd.	Halifax	UK	2.101*
Hambro Legal Protection Ltd.	Hambros	UK	15.301*
Clydesdale Bank Insurance Brokers Ltd.	Clydesdale Bank		11975
Co-operative Bank Financial Advisers Ltd	Co-operative Bank	UK	12503
Yorkshire Bank financial Services Ltd	Yorkshire Bank	UK	16.097*
Robert Fleming Insurance brokers (UK) Ltd.	Robert Fleming	UK	14.223**
BBV Brokers	Banco Bilbao Vizcaya	Spain	
BCP Brokers	Banco Commercial Portuguese	Portugal	210.56
Agencia Caixa	La Caixa	Spain	660.79

* = 1994 figure; ** = 1995 figure.

Source: own compilation

It is accepted that most of the banking products are related to general insurance products, such as credit related banking products and the credit insurance or overseas trade and the marine insurance etc (discussed further in chapter four). The banks, therefore, have an extra advantage in distributing general insurance products. The banks, before entering into general insurance distribution business, used to take out insurance cover against their banking products directly from traditional insurance brokers as assignee or via its customer. When banks realised that this is a good source of income they then established their own insurance broking subsidiaries and referred all insurance coverage to that broking company.

From Table 2.12, it is seen that the insurance broking subsidiaries, owned by banks, account for a significant amount of premium income. In some cases, for instance in the UK, these broking subsidiaries are in the top league table of the brokerage market. In a recent study by the ICC (1996), it is seen that in terms of premium income, nearly

a half of the top ten insurance broking companies (except the Lloyds Brokers) are owned by banks.

However, from Table 2.12, it is seen that the traditional distribution channels are still dominant in general insurance distribution. This is because the banks have still not entered into the distribution of large risk exposure insurance products such as marine, aviation etc, which require very special technical knowledge and skill and the banks have not acquired such expertise yet. Therefore, the traditional brokers still dominate these markets. From Table 2.12, it is seen that in France banks have only 4% market share in general insurance distribution, while in the life insurance sector (Table 2.8) it has 56% market share. The Netherlands have relatively better market share in general insurance business, i.e. 15%, while in Germany and Spain have only 2% and 3% respectively.

Table: 2.12
Bank's market share in general insurance distribution, 1995

France (1)		Germany (2)	
	%		%
Agents	40	Agents	75
MSI	29	Direct writers	2
Brokers	20	Brokers	15
Insurance employees	4	Banks	2
Banks	4	Branch offices	6
Direct & Others	3		
Italy (3)		Spain (4)	
	%		%
Agents	78.6	Agents	64
Brokers	15.8	Brokers	17
Direct Sales	5.1	Direct Sales	15
Others	0.5	Banks	3
		Others	1
UK*(5)		Netherlands (6)	
	%		%
Brokers	53	Brokers	55
Company Sales	16	Direct writers	20
People			
Tied Agents	5	Banks	15
Banks	1	Sales Forces	5
Direct Telesales	23	General agents	5
Others	2		

* = ABI figure

Source: Sigma/Financial Times

2.6.4. BANKS DIVERSIFICATION INTO GENERAL INSURANCE UNDERWRITING

Although the law of European countries allows (Table 2.4) the banks and building societies to own or to control general insurance subsidiaries, the banks are not very interested in the general insurance underwriting business. In our investigation, we have found not many general insurance underwriting subsidiaries owned/controlled by banks (appendix III). Some of the general insurance underwriting subsidiaries that are owned by banks is reported with their premium income in Table 2.13.

Table: 2.13
General insurance underwriting companies owned by banks, 1995

General Insurance Underwriting	Banks		Premium income (m) in Local currency
TSB General Insurance Ltd	TSB Group	UK	237966
Midland General Ltd.	Midland Bank	UK	N/a
Direct Line Insurance Ltd	RBS	UK	663726
Hamilton Insurance Company	HFC Bank	UK	36215
Ocidental Seguros	BCP	Portugal	13036
Omniver Iard	Kreditbank	Belgium	2.370
BBL Insurance	Banque Brussels Lambert	Belgium	124.00
Pacifica Non-Life	Credit Agricole	France	416431
Medical de France-Vie	Credit Lyonnais	France	
Mega Non-Life	Credit Commercial de Belgium	Belgium	209288
Ahorora Seguros	BBV	Spain	59777
Generali (Italy)	BCH (Spain)		10846661
Fideruam Assicurazioni	Istituto Mobiliare Italiano	Italy	24533.12
Ticino	Monta del Paschi de Siena	Italy	24553.86
CIDA, SIPEA	San Paolo	Italy	N/A
Bishopgate Insurance (UK)	AMEV/VSF (N.lands)		203884

Source: own compilation from various sources

The banks general insurance underwriting process is the same as the traditional general insurance underwriting companies. Therefore, we are not going to analyse here the general insurance underwriting process of banks. The banks, like life assurance underwriting business (discussed earlier in this chapter), can not underwrite

general insurance directly. They can underwrite general insurance business through separately owned general insurance underwriting subsidiaries. In those banks that underwrite general insurance business, their products are produced in the workshop i.e. underwriting office. These products then are supplied to banks marketing department but mainly to banks own insurance broking companies. The products are then sold from bank branch or broking companies or even through direct marketing channel.

In our investigation, we found that the general insurance underwriting companies that are owned by banks underwrite very simple general insurance products, such as household, accident and health insurance products. The banks are not doing well even in distributing these products. For instance, a recent survey by the KPMG (1997) shows that the banks and building societies household insurance penetration rates are falling. Banks have less than half the success of building societies in selling household insurance. Building societies have almost no success in selling household insurance to non-mortgage customers, whilst banks enjoy moderate success. Details are shown in the Table 2.14.

Table: 2.14
 Penetration rate of household insurance to banks & building societies
 mortgaged and non-mortgaged customers

	1994		1996	
	Mortgage customers	Non-mortgage customers	Mortgage customers	Non-mortgage customers
Banks	27.15%	7.80%	22.16%	6.87%
Building Societies	66.46%	0.16%	65.32%	0.17%

Source: Derived from Bancassurance Survey 1997, KPMG

No single company, in our investigation, has been found that underwrites large exposure of risks like marine, aviation, or even property insurance underwriting. This is because the banks may believe that underwriting these products is a very risky and/or less profitable area of business. Or the bank management may think that since

general insurance underwriting results⁵ are almost always negative (Table 2.15), it is not worthy to expand into general insurance underwriting business, and therefore, they mainly concentrate on the general insurance distribution (and life) activities only.

Table: 2.15

Non-Life Underwriting Results, 1996 Euro (m)		
Country	Underwriting results	Share in earned premium
Austria	-209.23	-3.81%
Belgium	394.72	6.07%
Denmark	-83.17	-2.27%
Spain	-649.93	-5.48%
Finland	-314.12	-17.53%
France	1630.94	4.69%
UK	-569.02	-1.49%
Italy	-2224.36	-11.63%
Luxembourg	50.13	10.39%
Netherlands	536.31	4.67%

Source: CEA 1997

Table 2.16 shows that the share in earned premium in the underwriting performance is mostly negative, therefore, underwriting general insurance by banks may increase the banks bankruptcy risks. However, we will test this empirically in *chapter five*.

2.7. THE RISKS AND BENEFITS OF DIVERSIFICATION INTO BANCASSURANCE ACTIVITIES

From the above investigation it is seen that the European banks have diversified into all insurance activities to some extent. Banks by utilising their resources (branch network, customer information etc) can provide various insurance products to the bank customers. It appears that the bank will benefit by diversifying into insurance,

⁵ General insurance underwriting profit is almost always negative. But they have investment income from where they have to make profit.

i.e. scale and scope economies [Diacon (1990); Dickinson and Dinenis (1992); Dinenis and Jung (1998)]. Although the original idea of entering into bancassurance was to sell insurance products through branch staff, with a view to adding new products lines to the same distribution outlets in order to minimise the cost (opportunities for scale and scope economies), banks have not yet been successful in this respect. This is because banks are still heavily reliant on traditional distribution channels like tied agent, direct sales force etc as branch staffs have not yet acquired the necessary skills to approach these products. They have not learnt about the technical knowledge of life assurance products and that's why they can not give standby answers to a customer's query with regard to life assurance. Therefore, they are heavily reliant on traditional insurance distributors who have now access to the branch with office space and other necessary secretarial facilities. In this case, they merely introduce traditional intermediaries rather than distribute. However, they can supply customers' data to the banks insurance personnel specialists as a prospective buyer. Therefore, there may be opportunities for the existence of scale and scope economies. Anyway, this is an empirical issue which needs to be tested separately.

On the other hand, by diversifying into insurance businesses, banks may increase their risks. Because banking business itself is regarded as a risky business. Insurance business, too, is regarded as a risky business. Therefore, diversifying into insurance business may increase banks' risk. On the other hand, by allowing asset diversification, banks may decrease their risks. We will test this empirically in Chapter five.

However, the risks depend on the level of business activities in insurance because the diversification into distribution activities and the diversification into underwriting activities are fundamentally different from each other in terms of risks. In distribution

activities as there is little risk as in distribution activities banks face 'selling risk' only, i.e. as long as they can sell they will get commission. But in underwriting activities, banks will have to bear the claims (if they arise) which is the main cost of insurance and this cost is much higher than the premium taken from the claimant. One may argue that not all the policyholders will claim and even not at the same time. Therefore, by pooling premiums as well as from the investment income (since significant part of the premiums is invested for further income) the claims can be met. But again, there may be an unexpected rise of mortality risk (for life assurance) or unexpected increase natural disasters, cyclone etc (for general insurance) or unexpected rise of loading risk i.e. expense risk or even unexpected rise of interest rate risk (as this directly effect the investment income). In all these cases, the banks total risk will increase or in the opposite case the total risks may decrease.

The underwriting of life assurance and the underwriting of general insurance are fundamentally different from each other because they bear different risk characters. Therefore, the risk effect of diversification into life assurance underwriting and the risk effect of diversification into general insurance underwriting should be treated separately.

In distribution activities, both life and general insurance distribution, the banks will not have to face these underwriting risks as the underwriting insurance companies will have to bear these risks. Therefore, we will test three categories of risks in chapter five namely, insurance distribution risks, life assurance underwriting risks and general insurance underwriting risks.

As it is mentioned earlier, the risks of the banks depend not only on the choice of underwriting activities but also on the choice of entry strategies. Entry via strategic alliance, where there is only distribution risks, or entry via creating own subsidiary,

where there is also underwriting risk, or other form of entries such as joint ventures or mergers and acquisitions will bear different degrees of risks (discussed in an earlier section).

2.8. CONCLUSION

This chapter attempts to describe the theoretical development of the new phenomenon of bancassurance and has investigated the diversification of banks into different insurance activities and has created bancassurance data sample. The data sample that has been created in this chapter will be used for the empirical analysis in chapter five. From the above discussion and investigation, it is seen that the diversification risks depend on (i.) the choice of entry strategy, and (ii) the choice of entry field, i.e. underwriting or distribution, and life or general insurance. Since it is seen (Figure 2.1) that the start-up approach and the mergers and acquisitions (and holding form) are likely to bear highest risks, we took these samples for our risks and return test in chapter five. These samples are grouped into three according to the choice of entry field of banks, i.e. life assurance underwriting, general insurance underwriting and insurance broking.

CHAPTER THREE

RECENT DEVELOPMENTS IN THE EUROPEAN INSURANCE INDUSTRY

3.1. INTRODUCTION

The purpose of this chapter is to critically examine the recent development of European insurance companies, particularly the development of ‘assurancebank’. To achieve this objective, we firstly outline the European insurance market place and its traditional distribution system and the development of new distribution channels in insurance. Secondly, we examine the recent development in insurance industries, particularly their diversification into banking business. We also create a data bank on assurancebank in this section. Finally, we develop a strategic model of assurancebank as a counter response to banks and test its validity.

The rest of this chapter is as follows: in section 2, we highlight the European insurance market. In section 3, discuss the traditional insurance distribution system and their new developments. In section 4, we define the term ‘assurancebank’ and draw a comparable model among bancassurance, assurancebank and allfinanz. In section 5, we discuss the recent development in insurance industry and create assurancebank databank. In section 6, we develop a strategic model of assurancebank as a counter response to banks, and finally in section 7 we conclude.

3.2. EUROPEAN INSURANCE MARKET PLACE

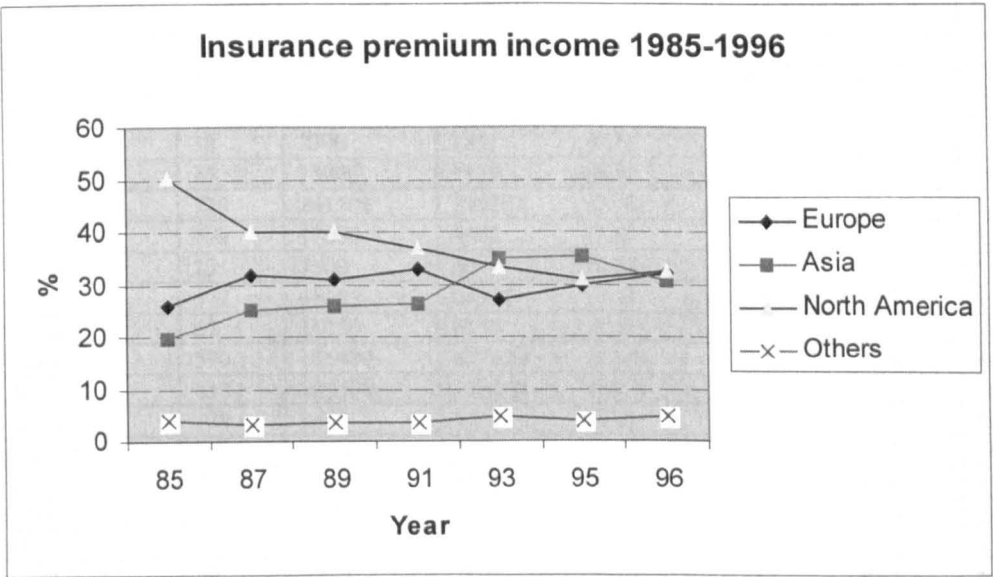
In 1996, the global premium income was \$2106 billion which is more than triple the 1985 value (Table 3.1). In the global market, Europe holds second position after the US and is slightly above Asia (including Japan). Currently Europe earns about 30% of world total premium income (Graph 3.1).

Table: 3.1
Global insurance premium income 1996-1985

Year	US\$bn
1996	2106
1995	2148
1994	1967
1993	1803
1985	632

Source: Sigma 1997/OECD 1997

Graph: 3.1



The five European countries- Germany, UK, France, Italy, and Switzerland, account for more than 75% of total business in terms of premium income. The UK is top in life market, with about 25%, and in the non-life market Germany is top, with more than 27%. If we add Spain and Netherlands with them the total figure reaches nearly 90%. Hardwick and Dou (1998), through their '*revealed comparative advantage*'

measurement, found that the UK has the most competitive life and non-life insurance in the EU, with France and the Netherlands in second and third places. They also found that Germany, which has the largest non-life industry and the second largest life industry in the EU (Table 3.2), was placed only sixth in the non-life category and eighth in the life category. In the following table (Table 3.2), we have shown the total premium income of each European country with market share and breakdown with life and non-life premium income including life and non-life market share. We have also reported the total number of insurance companies and the number of their employees' country by country in order to provide an overall idea of the European insurance market. The aggregation of the CEA (26 countries), EU (15) countries, and the EEA (17 countries) are also reported with market share of business.

Table: 3.2
Overview of European insurance industries, 1996 (ECU million)

Country	No of Insurance Co	No of Employees	Total Premium %	Life premium %	Non-Life premium %
Austria	78	30269	10584 (2.0)	4403 (1.5)	6180 (2.5)
Belgium	258	25070	11837 (2.2)	5261 (1.8)	6577 (2.7)
Switzerland	163	47510	24137 (4.5)	16075 (5.6)	8062 (3.3)
Cyprus	38	2300	285 (0.1)	149 (0.05)	136 (0.1)
Ck Republic	35	15000	1179 (0.2)	318 (0.1)	861 (0.03)
Germany	719	241700	116391 (21.8)	47790 (16.7)	68602 (27.8)
Denmark	N/a	17000	8662 (1.6)	5141 (1.8)	3520 (1.4)
Estonia	23	1500	60 (0.01)	4 (00)	56 (0.0)
Spain	372	48385	23161 (4.3)	10080 (3.5)	13080 (5.3)
Finland	57	10750	8155 (1.5)	6303 (2.2)	1851 (0.7)
France	570	135400	117029 (22.0)	70979 (24.8)	46050 (18.6)
UK	818	200500	113164 (21.2)	72985 (25.5)	40179 (16.3)
Greece	139	9600	1659 (0.3)	801 (0.3)	858 (0.3)
Hungary	N/a	18943	740 (0.1)	233 (0.1)	507 (0.2)
Ireland	149	10231	4590 (0.9)	2750 (1.0)	1840 (0.7)
Island	N/a	600	159 (0.0)	6 (00)	154 (0.1)
Italy	271	45250	35419 (6.6)	13633 (4.8)	21786 (8.8)
Luxembourg	94	1428	3029 (0.6)	2383 (0.8)	646 (0.3)
Netherlands	506	40770	27771 (5.2)	14610 (5.1)	13160 (5.3)
Norway	N/a	10000	5520 (1.0)	2452 (0.9)	3068 (1.2)
Poland	N/a	26000	2291 (0.4)	776 (0.3)	1515 (0.6)
Portugal	N/a	14171	4725 (0.9)	2243 (0.8)	2483 (1.0)
SE Sverige	N/a	18500	10340 (1.9)	6069 (2.1)	4271 (1.7)
SI Slovenia	N/a	3780	688 (0.1)	114 (0.04)	574 (0.2)
SK Slovenska	N/a	5079	346 (0.1)	89 (0.03)	257 (0.1)
Turkey	N/a	7500	947 (0.2)	140 (0.05)	806 (0.3)
CEA		987236	532868 (100.0)	285788 (100.0)	247080 (100.0)
EU		849024	496516 (93.2)	265432 (92.9)	231083 (93.5)
EEA		859624	502195 (94.2)	267890 (93.7)	234305 (94.8)

Source: Compilation from the CEA 1997

3.3. INSURANCE DISTRIBUTION CHANNEL

The success of an insurance company mainly depends on its effective distribution. Different writers classify insurance distribution channels in different ways. Whitaker (1995) conducted an in depth analysis of the insurance distribution channel from different angles. Proudfoot (1981) classified distribution channels into three categories i.e. full time, part time, others (direct mail). The Chartered Insurance Institute [Study Text of Contract Law and Insurance (1991)] classified five types of intermediaries. These are brokers, Lloyd's brokers, agents, consultants, home service representatives. Mercantile & General (1990) classified the channel into two broad categories i.e. direct channel, indirect channel. Traditionally the insurance products were distributed in the following simple way -

Insurers > Agents > Consumers (policy holders); or

Insurers > Consumers (policyholders).

The insurance companies used to employ agents on a part-time basis in order to sell their various insurance products to the customers in return for commission. Later on, amongst this group, a number of people have taken this as a full-time job and started to set up their own high street offices to offer to the customers different insurance companies' products. These are now known as brokers. Due to the internalisation of business, changes of public attitude and greater competition in the market, this situation is rapidly changing. Now there are a number of different types of intermediaries involved in insurance distribution, which makes the distribution

channel more complex than ever before. The distribution of insurance differs from company to company within the country. Even different countries have different distribution system for insurance according to the countries legislation (if any) for intermediaries, business tradition and culture. It is, therefore, justifiable to analyse each country's traditional channel of distribution country wise. We start from the UK, which is believed to have the most complex distribution system of insurance.

The UK:

In the UK, the following traditional distribution channels are found:

1. *Registered Brokers:* - A broker is an individual or firm whose full time occupation is the placing of insurance with the insurance companies. This type of broker is registered or enrolled with the Insurance Brokers Regulation Council (IBRC) under the Insurance Brokers (Registration) Act 1977. Only those who are registered in the IBRC can use the title as 'Broker'. No person or body corporate can use the title 'insurance broker' without the registration. It is a criminal offence. There are 15716 names on the IBRC on which 2118 are sole traders or in partnerships, and 2628 are body corporate brokers.
2. *Lloyd's Brokers:* - Only these types of brokers can place insurance to the Lloyd's. They are subject to the Lloyd's Acts (1871-1982), and the Lloyd's by laws. It is a condition of registration as a Lloyd's broker that the broker is also registered or enrolled with the Insurance Brokers (Registration) Act 1977.
3. *Non-Registered Intermediaries:* - For insurance intermediaries who are not registered brokers, there are two voluntary code of practice for them issued by the Association of British Insurers (ABI). The first code relates to general insurance business and the second to the life insurance of *non-investment type*.

First Code [General Insurance Business Code of Practice for All Intermediaries (including Employees of Insurance Companies) other than Registered Insurance Brokers)] recognises two types of intermediary:

- i. *Independent intermediary* - who act independently on behalf of the client, and,
- ii. *Company agent* - who are employed by one company or may represent a maximum of six companies.

The Second Code, which is known as Life Insurance (Non-Investment Selling) Code of Practice, recognises two further types of intermediary:

- i. *Intermediaries* - all persons including the employees of a life office, selling life assurance and who are not registered brokers.
- ii. *Introducers* - person who merely introduces a prospective policyholder to a life office but take no part in the subsequent selling process.

4. *Investment Type Insurance Intermediaries*: - Some long term insurance is recognised as of investment product under the Financial Services Act 1986. Under this act all person who wish to carry out 'investment business' must follow one of these two types:

- i. *Independent intermediary* - who acts on behalf of the client. They must secure a separate authorisation and are responsible for compliance of the requirements of the Financial Services Act 1986.
- ii. *Appointed Representatives* - who act as tied agents of an insurance company. They are not required to have separate authorisation under the Act.

An insurance intermediary who wishes to carry on investment business may secure an authorisation in the UK to do so from a number of sources:

- a. By applying directly to the Securities and Investment Board (SIB)

b. Through membership of a Self-Regulatory Organisation (SRO). There are a number of SRO's, each with their own rules regulating their members. They are FIMBRA (now PIA), IMRO, LAUTRO, SFA. Major clearing banks are members of the IMRO, LAUTRO.

c. Through certification by a Representative Professional Body. For example, the Law Society, the Chartered Institute of Accountants in England and Wales etc.

An agent in law is one who acts for another. In insurance the term 'agent' usually referred to the individual or firm whose main occupation is in another field. Estate agents, building societies, solicitors, accountants, garage proprietors, are often appointed as agents since their clients may require insurance cover which these intermediaries arrange.

Consultants - Intermediaries not registered in the Insurance Brokers (Registration) Council but who wish to mediate in insurance can use this title. They are also referred to as 'Insurance Adviser', 'Assurance Professional', and 'Financial Consultant'. They can work independently or as a tied.

Germany:

According to domestic law and commercial practice there are two basic classes of insurance intermediaries in Germany: the Agents and the Brokers. Agents deal with and are instructed by one or more insurance companies on a permanent contractual basis. Whereas brokers do not intermediate on a permanent basis instead intermediate periodically. Brokers in Germany work independently. The agents represent the insurers but brokers may be the agents of insurer or policyholder depending on from where he/she has received commission.

There is no restriction on intermediaries placing any types of insurance. Unlike other intermediaries in other European jurisdictions, there is no specific requirement of authorisation for insurance intermediaries in Germany. But they have to notify the local agency for trade registration like other traders. In case of company status, they have to register with the local commercial register, and have to follow the ordinary rules of German Company Law like any other company formation. Once intermediaries are registered as agents or brokers, they can then intermediate all kinds of i.e. life as well as non-life insurance business. German intermediaries are not obliged to submit annual accounts to any authority and there is not even a legal requirement for them to keep a bank account. Different types of insurance intermediaries are reported in Table 3.3.

Table: 3.3

German Insurance Intermediaries

Channel	Number
Full-time Tied Agents	50000
Part-time Tied Agents	270000
Salaried Sales Force	25000
Independent Agents	5000
Brokers	4000

CAPA Conseil, Paris, 1993

France:

There are four types of intermediaries found in France for insurance distribution. These are:- (i.) General agents, (ii.) Independent brokers and brokerage firms, (iii.) Salaried employees of insurance companies, and (iv.) Salaried employees and agents of insurance agents (sub-agents) of individual brokers and of brokerage firms. General agents are individuals who act as an agent for insurance companies and they represent the insurers. Brokers on the other side, may be individuals or a firm with company status who acts for the insured. Unlike Germany, the French intermediaries are not free from authorisation. They are regulated under the French Law. They need authorisation and registration for doing insurance intermediary business. But they do not need separate authorisation and registration for conducting life and non-life

insurance businesses. Different types of French insurance intermediaries are reported in Table 3.4.

Table: 3.4

French Insurance Intermediaries

Channel	Number
Tied Agents	19700
Agency Employees	51000
Brokers	2400
Employees of Brokers	16000
Employed Salesman (life)	25000

CAPA Conseil, Paris, 1993

Italy:

Under the Italian law, there are two types of insurance intermediaries. These are:- (i). Tied agents, and (ii). Independent insurance brokers. Agents are defined as those who permanently undertake, for a remuneration, to promote the execution of contracts on behalf of a principal within a specified territory. [Article 1742, Civil Code]. On the other hand a broker is one who professionally places two or more parties in contract for the purpose of entering into a contract without being connected with either of such parties by way of collaboration, employment or representation. [Article 2754, Civil Code]. Different types of Italian insurance intermediaries are reported in Table 3.5.

Table: 3. 5

Italian Insurance Intermediaries

Channel	Number
Tied Agents	18200
Independent Agents	3800
Sub Agents	20000
Employed Salesman	3600
Independent Producers	40000
Brokers	1260 (individual) & 695 (organisations)

CAPA Conseil, Paris, 1993

Spain:

In Spain, the intermediaries are classified in the following ways according to their domestic law. It classifies agents in the following way: (i). Private individuals and legal persons; (ii.) Agents; (iii.) Brokers; (iv.) Employees, and (v.) Sub agents. Agents may

be tied agents with no power of representation and tied agents with powers of representation of the insurance company. Different types of Spanish insurance intermediaries are reported in Table 3.6.

Table: 3.6
Spanish Insurance Intermediaries

Channel	Number
Tied Agents	19000
Agency Employees & Sub Agents	70000
Brokers	4700

CAPA Conseil, Paris, 1993

The Netherlands:

Netherlands was the first country in Europe, which introduced legislation in 1952 for the insurance intermediaries. This law was replaced with amendments in 1991 as the Insurance Intermediaries Act 1991. In Dutch law, there are two types of intermediaries for distributing insurance. These are (i). Independent intermediaries, and (ii). Tied agents, acting pursuant to an agency agreement with particular insurance company. There are few tied agents, and most of the intermediaries are independent. One unusual thing for the Dutch intermediaries is that, in Netherlands, the intermediaries with the highest professional qualifications are sworn in by the district court, and they are then entitled to use the title ‘makelaar’. Another interesting thing is that the Netherlands has ‘Insurance Exchange Market’ like a stock exchange market. In Amsterdam and Rotterdam the ‘Makelaars’, underwriting agents and/or companies meet there to conduct insurance business. Different types of Dutch insurance intermediaries are reported in Table 3.7.

Table: 3. 7
Dutch insurance Intermediaries

Channel	Number
Tied Agents	18998
Agency Employees	5684
Trainee Agents	878
Brokers	4268

CAPA Conseil, Paris, 1993

Belgium:

According to domestic law, there are two types of intermediaries in Belgium. These are (i.) Agents; and (ii.) Insurance writers. Insurance companies and insurance investigators employ agents. Insurance writers are not appointed as agents or investigators, They are independent and manage their own portfolios. These insurance writers are of two types. This two are (ii.a.) Brokers; and (ii.b.) Agents. Different types of Belgian insurance intermediaries are reported in Table 3.8.

Table: 3.8
Belgium Insurance intermediaries

Channel	Number
Full time Independent Intermediaries of which brokers (app)	12000
Part time Intermediaries	6000
Employed Salesman	12000
Staff Working for Brokers	2500
	10000

CAPA Conseil, Paris, 1993

Denmark:

There is no specific legislation for insurance intermediaries in Denmark. Just the general Danish law about marketing practices, accounts and companies etc. which applies equally to insurance intermediaries. But the professional Danish brokers association, which is a member of the BIPAR, which works on a voluntary membership basis, has laid down some rules for professional development. In domestic law and commercial practice in Denmark the following types insurance

intermediaries exist. (i.) Insurance Brokers on Commercial line, (ii.) Insurance Brokers on Non-commercial line, (iii.) Lloyds Brokers, (iv.) Insurance Advisers, (v.) Insurance Agents, (vi.) Sub-agents, and (vii.) General Insurance Agents.

Brokers on commercial line business are mostly members of the Danish Association of Insurance Brokers. These brokers are independent and act for the insured. They chose freely among the insurance companies in arranging cover for various risks for their clients. But they receive commission from the insurance companies. Brokers on non-commercial line business are often lawyers or accountants who acts on behalf of their clients in order to arrange insurance coverage. Section 220(2) of the Act on Insurance Business allows certain numbers of Lloyds Brokers to assist in placing Danish non-life risks outside Denmark. Insurance Advisers advice their clients to cover the risks according to their clients need. They receive payment from their clients and maintain their independence from the insurance companies. Insurance agents on the other hand are employed by insurance companies or have an agency agreement with an insurance company. These agents are dominant in Denmark for insurance distribution. They some times employ other persons to act as sub agents on their behalf who are authorised by their insurance company. These agents are called Direct Sales Force.

Table: 3. 9
Danish Insurance intermediaries

Channel	Number
Direct Sales Force	2500
Brokers	200

CAPA Conseil, Paris, 1993

In the above sections, different types of insurance intermediaries have been discussed from the different European countries' context. In the following section, we will discuss different insurance intermediaries on the basis of the EC Directives.

3.3.1. THE EC DIRECTIVES ON INSURANCE INTERMEDIARIES

The EC has a directive with regard to insurance agents and brokers. This is The Council Directive on Insurance Agents and Brokers (77/92/EEC). It offers another recommendation on insurance intermediaries. This is The Commission Recommendation on Insurance intermediaries (92/48/EEC). Before this some member states had no legislation for intermediaries and some members had legislation for intermediaries. The Netherlands was the first to introduce legislation on intermediaries in 1952. France started to regulate from 1966 and later on Belgium. On the other hand, the UK, Denmark, Germany did not have any legislation for intermediaries. The UK introduced legislation in 1977 named the Insurance Brokers (Registration) Act 1977.

The Directive (77/92/EEC) notified three types of insurance intermediaries. This is in Article 2.1 a to c. The three types of intermediaries are (i.) Insurance and reinsurance brokers; (ii.) Insurance agents; (iii.) Sub-agents. The article also defined all of these intermediaries.

(i.) Insurance and reinsurance brokers:

These types of intermediaries are defined as 'professional activities of persons who, acting with complete freedom as to their choice of undertaking, bringing together, with a view to the insurance or reinsurance of risks, persons seeking insurance or reinsurance and insurance or reinsurance undertakings, carry out work preparatory to the conclusion of contracts of insurance or reinsurance and, where appropriate, assist in the administration and performance of such contracts, in particular in the event of a claim' [Article 2.1 (a)].

(ii.) Insurance agents:

These types of intermediaries are defined as ‘professional activities of persons instructed under one or more contracts or empowered to act in the name of or on behalf of, or solely on behalf of, one or more insurance undertakings in introducing, proposing and carrying out work preparatory to the conclusion of, or in concluding contracts of insurance, or in assisting in the administration and performance of such contracts, in particular in the event of a claim’ [Article 2.1 (b)].

(iii.) Sub-Agents:

These types of intermediaries are defined as ‘ activities of persons other than those referred to in (a) and (b) who, acting on behalf of such persons, among other things carry out introductory work, introduce insurance contracts or collect premiums, provided that no insurance commitments towards or on the part of the public are given as part of these operations’ [Article 2.1 (c)]. The article 2.2 (a) (b) (c) gave the likely domestic member countries comparisons of titles of the above-classified insurance intermediaries.

There is a special condition in addition to the general for all to be fulfilled by the intermediaries categorised in 2.1 (a) in Netherlands [Article 5.2. 77/92/EEC]. These conditions are-

- ☐ where the beneficiary wishes to work as a ‘makelaar’, he must have carried on the activities concerned in a business where he was in charge of at least ten employees;
- ☐ where the beneficiary wishes to work as an ‘assurantiebezorger’, he must have carried on the activities concerned in a business where he was in charge of at least five employees;

- Where the beneficiary wishes to work as an ‘erkend assurantieagent’, he must have carried on the activities concerned in a business where he was in charge of at least two employees.

In the 1977 Directive, insurance brokers are defined as persons ‘acting with complete freedom as to their choice of undertaking [Article 2.1 (a)]. Although the directive did not suggest any method by which brokers’ independence can be assessed, the Recommendation imposes a duty on brokers to disclose their connection with insurance companies. ‘The person defined in Article 2.1.(a) of the Directive 77/92/EEC shall disclose:

- To persons seeking insurance or reinsurance of risks, any direct legal or economic ties to an insurance undertaking or any shareholdings in or by such undertakings which could affect the complete freedom of choice of insurance undertaking, and
- To a competent body, as determined by the Member State, the spread of business with different insurance undertakings over the previous year.’

The recommendation provides that all intermediaries should secure and maintain a minimum level of professional competence. It may pose problems for part-time agents. It also causes a problem for banks, building societies and other retail financial outlets whose involvement are increasing day by day. This problem is compounded by virtue of the broad range of persons mediating in insurance, all of them are now covered by the recommendation. The titles of different intermediaries in different European countries are reported in Table 3.10.

Table: 3.10
Title of intermediaries in different EC Member States

Country	Insurance and Reinsurance Brokers	Agents	Sub-Agents
Belgium	-Courtier d'assurance Verzekeringsmakelaar, -Courtier de reassurance Herverzekeringsmakelaar	-Agent d'assurance, -Verzekeringsagent;	-Sous-agent, -Sub-agent;
Denmark	-Juridiske og fysiske personer, som driver selvstaendig virksomhed som formidler ved afsaetning af forsikringskontrakter	-Forsikringsagent;	-Underagent;
Germany	-Versicherungsmakler, -Ruckversicherungsmakler;	-Versicherungsvertreter;	- Gelegenheitsv ermittler, -Inkassant;
France	-Courtier d'assurance, -Courtier d'assurance maritime, -Courtier de reassurance;	-Agent general d'assurance;	-Mandataire, - Intermediaire, -Sous-agent;
Ireland	-insurance broker, -Reinsurance broker;	-Agent;	-Sub-agent;
Italy	-Mediatore di assicurazioni, -Mediatore di riassicurazioni;	-Agente di assicurazioni;	-Subagente;
Netherlands	-Makelaar, -Assuratiebezorger, -Erkend assurantieagent, -Verzekeringsagent;	--Gevolmachtig agent, -Verzekeringsagent;	-Sub-agent;
U8K	-Insurance broker;	-Agent;	-Sub-agent;
Spain	-Agentes libres de seguros, -Corredores de reaseguro;	-Agentes afectos de seguros;	-Subagentes de seguros;
Portugal	-Corretor de seguros, -Corretor de resseguros;	-Agente de seguros;	- Submediador;

Source: Insurance Intermediaries in the EEC, Lloyds of London Press 1992

3.3.2. DEVELOPMENT OF NEW DISTRIBUTION CHANNELS IN EUROPE

The distribution network for insurance companies and banks are continuously changing. In addition to traditional channels, the insurance companies currently rely on banks' channels for insurance distribution, and banks, to a lesser extent, rely on insurance distribution channel for banks' products. One is called 'bancassurance channel' and the other is called 'assurancebank channel'. Due to the rise of these two channels, the traditional channels of insurance distribution, like the brokers, agents etc, are declining rapidly (discussed in Chapter four). On the other hand, traditional

banks channel like the bank branch network, is also declining. In both cases, the reduction of distribution costs is a prime objective. For this reason, the traditional insurance distributors are facing a serious threat due to the banks' rapid expansion to insurance distribution, and the banks' employees are losing their jobs due to the rapid closure of bank branches. Some banks and insurance companies have gone one step further. Sophisticated IT has made life easier, and they, therefore, have introduced another new channel of distribution, which is referred as 'Direct Channel'. Although these channels are relatively new, they are getting rapidly stronger. We will discuss these channels in the following sections.

i. Direct Channel:

Direct marketing channel in insurance is growing faster day by day in Europe. Through this channel customers can take stand by products over the telephone. It can be done through direct mail, telephone sale, company sales staffs or company agents. No intermediaries are involved here. This is to cut the commission cost. This is the alternative tool of insurers to compete with the bankers in insurance distribution. Major UK insurers have now direct line approach as an extra channel. Some banks are also approaching this strategy to minimise the cost. The launch by the Royal Bank of Scotland's Direct Line into the UK financial services, especially in the motor insurance market in 1984, heralded the beginning of a new era in financial service distribution. The customer proposition, delivered through a Telephone Call Centre, was a combination of very competitive prices and a superior service standard. The Direct Line was an immediate success, and this success led to the Midland Bank entering the direct banking market with the launch of First Direct in 1989. Currently, a number of banks as well as insurance companies have introduced this channel of

distribution for banking and insurance products. Some of the direct marketing (banking) outlets of European insurance companies are shown in Table 3.11.

Table: 3.11
Insurance companies in tele banking

Insurer	Tele Banking	Established
Allied Dunbar Assurance	Allied Dunbar Mortgage	1994
Churchill	Churchill Direct	1989
Colonial Mutual	Colonial Direct	1995
Insurance Club	Insurance club	1995
Preferred Assurance CO	Preferred Direct	1982
Prudential	Prudential Direct	1994
Sun Alliance	Sun Bank	1989
Scottish Widows	Scottishwidow Bank	1995
Trygg-Hansa	Aksam	1990
AXA	AXA Direct	1992
Generali	Genertel	1994
Maprre	Mares	1996
AGF	Poseidon (Greece)	1994
Zurich Insurance Group	Zuritel	1994
General Accident	GA Vox (France)	1991
GRE	Guardian Direct	1995

Source: own compilation from various sources

ii. 'Bancassurance' and 'Assurancebank' channels:

'Bancassurers' are the new entrants in the insurance distribution channel. Bancassurers are those who distributes insurance through their bank branch network to its existing customers. They are rising rapidly in Europe. In France, the distribution of insurance by banks count for more than 50% of the total distribution market. In other European countries, the market share of banks is 15-30%. Major commercial banks and building societies in Europe now have linked up with insurance distribution either with their own insurance underwriting companies or with traditional insurers in a form of strategic alliance or both. Details are discussed in chapter two. The assurancebank' channel is also growing to a lesser extent. *Assurancebank* is a term where the banking products are sold by the insurance companies. With this channel, the insurers can provide banking products as well as insurance products directly to the consumers.

3.4. ASSURANCEBANK AND ITS DIFFERENCE FROM BANCASSURANCE AND ALLFINANZ

When insurance products are produced and/or sold through bank's country wide branch network, this is called *bancassurance*. But when banking products are produced and/or sold through insurance companies, this is called *assurancebank* (discussed in chapter two). Unfortunately, most writers mention both as *bancassurance*. There is a clear difference between *bancassurance* and *assurancebank*.

Table: 3.12
Bancassurance vs. Assurancebank vs. Allfinanz model

Bancassurance model		Assurancebank model		Allfinanz model	
Banks as principal	yes	Insurance Co as principal	Yes	Banks as principal	Yes
Insurance Co as principal	No	Banks as principal	No	Insurance Co as principal	No
Banks parent with insurance -		Insurance CO parent with bank -		Banks parent with insurance	
- subsidiary	yes	-subsidiary	Yes	-subsidiary	Yes
- strategic alliance for joint sales	yes	-strategic alliance for joint sales	Yes	-strategic alliance for joint sales	Yes
- joint venture	yes	-joint venture	Yes	-joint venture	Yes
- majority/minority equity holding only but not engage in insurance directly or indirectly	No	-majority/minority equity holding only but not engage in banking directly or indirectly.	No	-majority/minority equity holding only but not engage in insurance directly or indirectly	No
Banks parent with		Insurance CO parent with		Banks parent with	
-life assurance distribution	yes	-commercial banking	Yes	-life assurance distribution	Yes
-life assurance underwriting	yes	-investment banking	Yes	-life assurance underwriting	Yes
-general insurance distribution	yes	-building societies	Yes	-general insurance distribution	Yes
-general insurance underwriting	yes	-tele banking	Yes	-general insurance underwriting	Yes
-life and general both distribution and underwriting	yes		-	-life and general both distribution and underwriting	Yes
-securities dealing	No	-securities dealing	No	-securities dealing	Yes
-industrial assurance	No				
-reinsurance co	No	-reinsurance co	No		
Bank Holding CO with		Insurance Holding CO with		Bank Holding CO with	
-autonomous insurance management within the group	yes	-autonomous banking management within the group	Yes	-autonomous insurance management within the group	No
Building Societies with insurance business	yes	Insurance CO with Building Societies	Yes	Banks with Building Societies	Yes
<i>Savings bank in insurance</i>	yes		Yes	<i>Savings bank in insurance</i>	Yes
Bank's insurance subsidiaries' banking subsidiary	No	Insurance co's banking subsidiary's insurance subsidiary	No	Bank's insurance subsidiary's banking subsidiary	No
French word UK origin European based	yes			German word German origin and German based	Yes

Source: own compilation

Not only that, some authors think bancassurance and allfinanz is the same. But allfinanz includes securities dealing, whereas bancassurance does not include securities dealing. We, therefore, have drawn a comparative model of 'Bancassurance', 'Assurancebank' and 'Allfinanz' in Table 3.12.

3.5. RECENT DEVELOPMENT IN INSURANCE BUSINESS

Like the banks, European insurance companies also facing heavy competition due to implementation of the 'single licence' for insurance within the Member Countries [Hardwick (1997)] and the banks direct involvement in insurance business [Dickinson (1997)]. Therefore, the insurance companies are also trying to become involved in banking activities. A study by the Committee de European Assurance (1994) also shows a number of financial conglomerates (Appendix X). But the study did not provide information as to which insurance companies have diversified and what they are.

The insurance companies entry into banking business start quite recently, mainly in mid nineties and, therefore, at this stage it is very difficult to conduct a thorough study and their impact. As a starting point in order to create a database for future analysis, we investigate which are the insurance companies in Europe who have entered into banking business? And what are they? We took the top 100 European insurance companies from to 'Top 15000 European'. We than start searching manually as to which insurance companies have diversified into banking through press clippings, companies annual reports etc. The result of this investigation is shown in Table 3.13.

Table: 3.13
European insurance companies banking subsidiaries, 1996

Insurance Groups	Top 100 1991	Banking subsidiaries	Area of Operation	Equity
Allied Dunber Assurance	33	Allied Dunber Bank PLC Allied Dunber Bank International Ltd		100%
Commercial Union	13	Delta Lloyd Bank	Netherlands	99.7%
Lloyds Abbey Life	24	Lloyds Bank	Channel Island	100%
Scottish Widows Fund & Life	X	Scottish Widows Bank PLC		100%
Standard Life	6	Bank of Scotland	UK	34.8%
Corp Mapfre Cia internacional de Recsoyuros	X	Banca Mapfre	Spain	100%
Achmea Holding	X	Achmea Bankholdings, Staal Bankiers	Spain	92%
Aegon	5	Spaarbelg Bank, FGH Bank	Netherlands	99.99%
Assurantieconcern Stad Rotterdam anno	X	SR-Bank	Netherlands	100%
INA	41	Banca Marino SpA	Italy	80.87%
Riunione Adriatica de Sicurta	45	Rasbank SpA	Italy	65%
AGF	8	Banque du Phenix	France	100%
AXA Group	4	AXA Banque	France	96%
GAN Group	78	Banque pour l'indushrie Francaise, Union industrielle de Credit	France	98% 97%
Grovpama SA	X	Banque Financiere Groupona	France	75%
UAP	X	Banque UAP, Banque Worms, BNP Banque IPPA	France	14.34% 48.57%
Alm. Brand af	X	Alm. Brand Bank	Denmark	100%
A/S Forsikringsselskabet Coden	X	Coden Bank	Denmark	n/a
P&V Assurances Ste Co-op	X	Banque Nagelmackers	Belgium	100%
Royale Belge	68	Banque Ippa	Belgium	100%
Allied Dunber	33	Allied Dunber Mortgage Ltd	UK	100%
Commercial Union	13	CU Financial Holdings	UK	100%
Legal & General	10	Legal & General Finance PLC Legal & General Mortgage Ltd	UK	100%
Norwich Union Assurance Grou	7	General Practice Finance Corporation	UK	100%
Prudential Corp	1	Prudential Financial Services Ltd	UK	100%
Royal Sun Alliance Group	6*	Sun Alliance Investment Mgt Ltd	UK	100%
Scottish Amicable Life Assurance Society	N/a	Scottish Amicable Finance Ltd	UK	100%
Alieanza Assicurazioni	X	Banca Ambrosiano Veneto	Italy	16.02%
La Fondiaria	47	Mediobanca	Italy	15%
Skandia Insurance Co	32	Skandia Banken Skandiabanke Fondkomission	Sweden	100%
Trygg-Hansa AB	49	Trygg-Banken, Trygg-Hansais	Sweden	n/a
ING Group	2	ING Bank	Netherlands	100%
Hafnia	N/a	Hafnia Services	Denmark	100%
Topsikring	X	Top Dank, Top Center Bank	Denmark	100%
Tryg-Baltica Group	N/a	Den Danske Bank, Baltica Bank (1987) Hambros (UK)	Denmark	10%
Forties	N/a	Spaarbank Breukelin Metropolitan Bank VSB Bank, ASLK-CGER Bank	Belgium	100%
Aachener & Muenchener	X	Bank fuer Gemeinwirtschaft (JV)	Germany	100%
Athena	X	Athena-Banque		100%

Source: own compilation from various sources

From Table 3.13, it is seen that that among Europe's largest 100 insurance groups, only a small number of them have entered into banking business, and these banks offer very few banking products such as mortgage and loan. The insurance companies commonly used products and their mortgages and loan value are shown in the Table 3.14 and 3.15 respectively.

Table: 3.14

Banking products range supplied by insurers

Banking products	Suppliers	Comments
Current accounts, cheque books etc.	Larger insurers through separate subsidiaries	-
Mortgages	Most insurers	-
Credit/debit cards	Few insurers	AGF's Dianars Club card
Loan	Most insurers	-
Investment	Most insurers	-
Annuity	Almost all insurers	-
Unit trusts	Most insurers	-
Securities dealing	Larger insurers	-
Foreign exchange dealing	Larger insurers	-

Source: own compilation

Table: 3.15

Insurance companies mortgages and loans value (local currency) 1995

Country	Mortgages loan	Loans other than mortgages
Belgium	202181	19477
Denmark	5026	2373
France	N/A	56922
Germany	112686	399001
Italy	2042200	N/A
Netherlands	39256*	93895*
Portugal	954	564
Spain	44024**	4845
Sweden	11993***	32577
Switzerland	27292	26479
UK	3482****	6121

* = 1994 figure, ** = 1989 figure, *** = 1990 figure, **** = 1988 figure

Source: Insurance statistics year book 1988-1995 & OECD 1997

We have shown in Chapter two that the banks in Europe are engaged in insurance business. They are permitted not only to engage in insurance distribution but also in the core insurance activities, i.e. underwriting of insurance. This is a serious threat for

insurance companies. Earlier when banks started distribution of insurance, insurance companies used to underwrite the insurance and banks used to distribute these insurance products through their banks branch network. In this way, they had a principal-agent relationship, insurance companies as principal and the banks as agent. Such an agency relationship between the insurance companies and banks was a threat to traditional insurance intermediaries as these banks used to compete directly with the traditional insurance intermediaries in the intermediaries market. The insurance companies, by employing banks as insurance intermediaries, used to get an extra strong channel for distribution of insurance in addition to their traditional channel.

Soon afterwards, when the banks realised that insurance business is a good prospect for them, they started to think about it. As they had now learnt the 'know how' of distribution of insurance, they started withdrawing support for distribution from traditional insurance companies. Instead, they established their own underwriting insurance ventures and distributed their own underwriting products through their own bank branch network. Therefore, the insurance companies not only lost their strong distribution channel but also directly faced competition from the banks. This time not the intermediaries but the underwriters face a serious threat from banks.

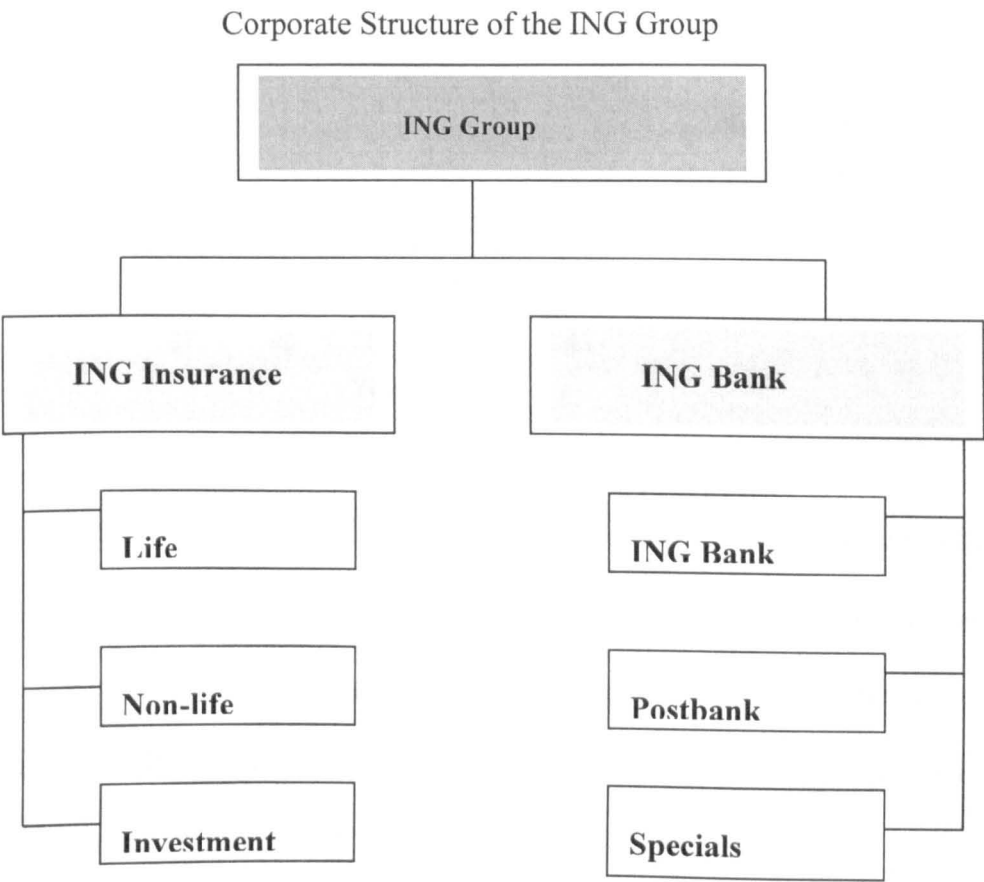
In this situation, the insurance companies have three options: 1. Do nothing; 2. Improve existing services possibly with reduced price; 3. Counter respond. If the insurance companies do nothing, they will lose their market ultimately. The second option is to improve existing services. Diacon (1990c), Press Kit (1991) mentioned some of the following key factors as necessary in order to improve services: (i.) Quality of service; (ii.) Technological development; (iii.) Effective distribution and marketing; (iv.) appointment of good investment expertise, (v.) Innovation of products but not duplication or copying of products; (vi.) Lower pricing and higher quality of products in

the products line; and, (vii.) Advertisement of service quality, products and pricing. All these factors are very important and desirable but not enough within this competitive environment for insurance companies. Further more, one-third of customers now prefers everything under one roof [Swiss Re (1992)]. However, in this circumstances, Dickinson & Dinenis (1992) suggested the following:- discourage any initial predatory pricing; develop alternative distribution channels; increase of corporate image through advertise etc.; improve the size and quality of direct sales forces; support services to agents and brokers like laptop, training etc.; and finally a counter reaction, i.e. to acquire banks by insurance companies.

Dickinson & Dinenis (1992) further suggested that 'Insurance companies would adopt strategies which were conditioned by the strategies of banks, since the banks would be the prime mover in the game'. They suggested that if banks are less aggressive in nature, i.e. short-term maximising position, then insurance companies would tend to adopt a more passive strategy and may even seek to encourage the strategy in this direction. If the banks were to adopt a more aggressive, predatory strategy, then the insurance companies would react more positively.

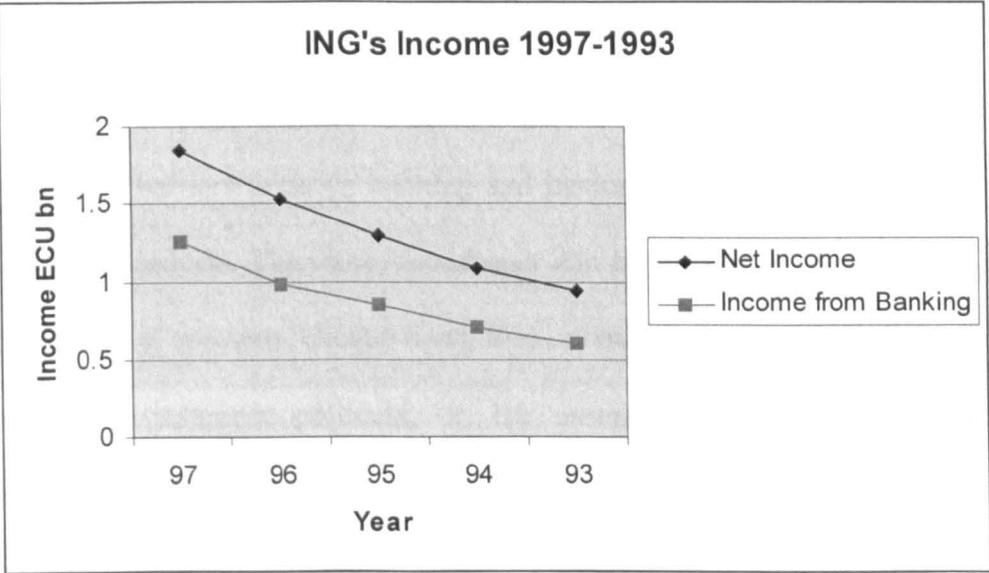
Currently we see that the banks are more aggressive in nature. In this situation, how insurance companies should respond? A simple answer is to acquire banks by insurance companies. This in our opinion is 'assurancebank' (defined earlier in this Chapter). The ING, one of the leading providers of insurance products in Europe has already adopted this strategy (Figure 3.1). From the corporate structure of the ING (Figure 3.1), it is seen that the ING, in addition to its life assurance and general insurance business, has diversified into banking and investment business activities through different subsidiaries.

Figure: 3.1



In 1997, the ING's total net income was 1.8396 billion Euro and in the same year it earned 1.2579 billion Euro from banking operation (Graph 3.2). It appears that the ING is doing well in its banking operation and, therefore, other competitors may be interested in assurancebank because of ING's success. Other large insurance groups in Europe, such as Prudential, Aegon, etc have already moved in this direction (Table 3.4), although the largest European insurance group, the Allianz has stated not to become involved in banking,

Graph: 3.2



mainly due to the potential increases of risks and decreases of profitability. We will test this issue empirically, i.e. the risks and return effects of diversification of insurance companies into banking, in Chapter six. However, the insurance companies that have already entered in banking business, are still struggling (for instance, the ING Group) in integrating the services at operational level. There needs to be more integrated corporate structure along with a sophisticated high tech IT network to deliver the financial products. We, therefore, propose an integrated model of 'assurancebank' in order to overcome such problems.

3.6. A SIMPLE MODEL OF ASSURANCEBANK

3.6.1. THE MODEL

We imagine 'X', a medium size life assurance company (it can be general insurance or composite insurance company). Due to the entry of commercial banks and building societies into life assurance distribution as well as underwriting activities, it is losing its market share. The direct competition in distribution as well as in underwriting with banks and, at the same time, the withdrawal of strategic alliance support of banks

from insurance companies, have threatened them heavily. The existing clients are also moving slowly towards banks because of the changing habits of customers. They want all of their financial products from a single source¹. Since the regulators removed the regulatory barriers between banking and insurance, banks have extended a range of financial products. Therefore, a customer can buy from his/her bank all the banking products, i.e. accounts, cheque book, loan, overdraft facilities, and direct debit as well as all the insurance products, i.e. life assurance, pension, household insurance, mortgage insurance, motor insurance, credit insurance, and above all the investment products.

Mr. 'A', a customer of the insurance company 'X', has a life policy worth 75 thousand pounds. This life policy will have a policy number like traditional policy number. This number will be the key between Mr. A and the company X. Mr. A has a regular income (monthly, for instance) which currently goes to his traditional bank account. The annual gross income of Mr. A is 25 thousands pounds. He has a credit card and the credit limit is 4000 pounds. His bank has given him Over Draft facilities (OD). He wants to buy a house with 95% mortgage. He was preparing to apply to a building society for a mortgage. His bank manager, knowing that, proposed to him to apply for a mortgage in the bank. Mr. A has a motor car that is insured through a local insurance broker. The annual premium is 400 pounds. He goes for holiday every year and takes holiday insurance. The average premium is 75 pounds. He also pays 20 pounds premiums for his card protection insurance. Mr. A has some direct debits. These are for electricity bill, gas bill, water bill, council tax bill and a telephone bill. This goes from his bank through direct debit mandates.

¹ A recent study supports this argument ['Life assurance Marketing' Swiss Re 1993].

Now, Mr. A is planning to switch off his life policy and going to join with his bank to take a similar insurance. Can the insurance company 'X' give similar facilities to Mr. A? If it can, he may stay with the company X.

Yes, X insurance company can by adopting this model.

The policy account will be used as if it is also a bank and credit card account. A mortgage will be offered to Mr. A as he wants to buy a house. As his gross salary is 25 thousands pounds he can borrow up to 75 thousands pounds, according to (UK) normal mortgage custom or more, i.e. 95% mortgage. The mortgage indemnity insurance will be taken against this mortgage like other banks and building societies do. A life protection cover will be given to Mr. A against the mortgage amount. A building insurance will also be given for the property being purchased by Mr. A.

He will be given a credit/debit card depending on his financial strength and the number of years he is running the life policy like other bankers, where they require certain amount of credit scoring. As regular money comes to this life account, all the direct debits will be honoured as long as there is sufficient amount of money, including the credit zone limit like other traditional bankers. Mr. A may get OD facilities against his regular salary, and/or he may get it after two or three years of running the policy against his insurance policy. Since a life fund is created from his life policy which is traditionally invested somewhere else, now simply by switching off the traditional investment method and area, this life fund can be just invested to Mr. A as an investment if s/he requires any loan, and thus, get the interest from him/her instead of other investors. There might be government restrictions to invest in such ways but some of the funds at least can be invested.

A motor cover can be arranged within the group if it is a composite company, or if it has a separate general insurance company, or if not, company X can make a strategic

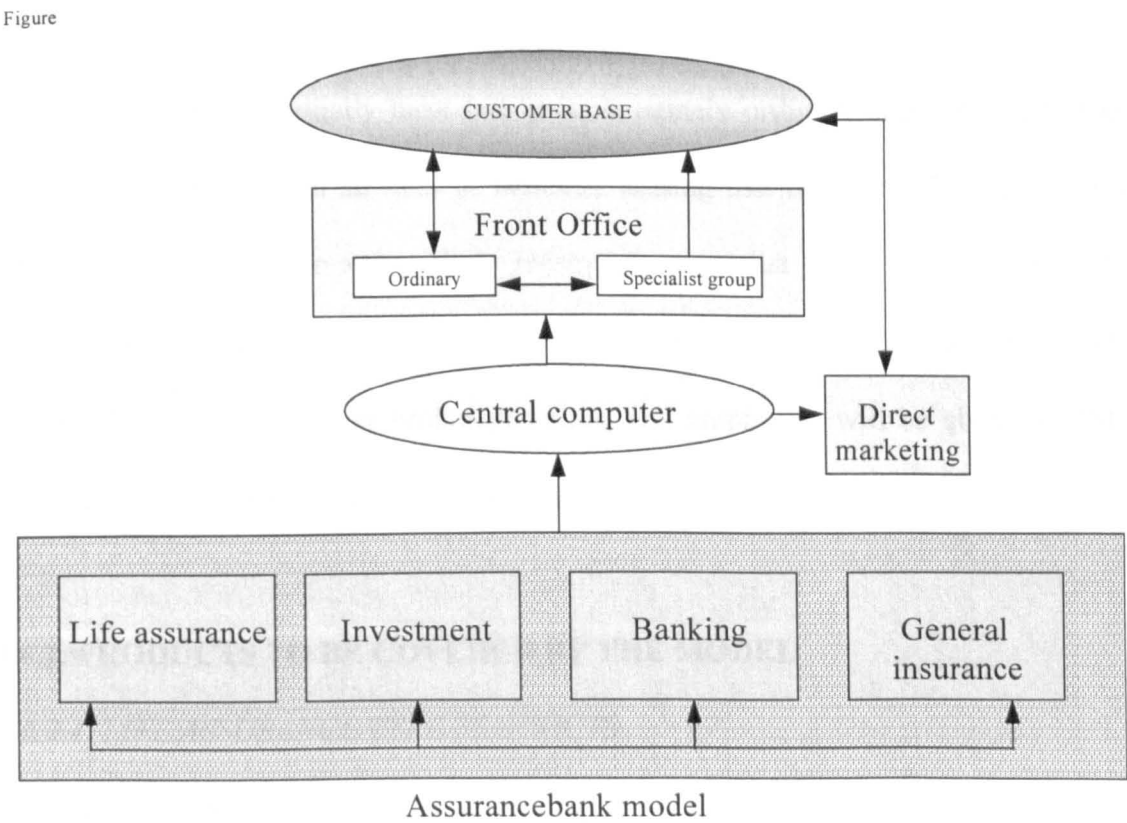
alliance with one. As a large number of business volumes will pass through the company X, X will get special commission rate compared to the traditional broker's rate. The company X then can supply this relatively cheaply to its client to make sure the price is relatively lower or at least equivalent in the market. Similar arrangements may be made for his household, and holiday insurance. A plastic card, debit or credit card, will be given with the policy number, which will be used as account number for all these products, including as a card number. When customer A has any inquiry he will simply show his magnetic stripe plastic card or if over the telephone, simply quote his policy number (which is also account number). One account number may be caused problem for a series of financial products, i.e. banking as well as insurance, which he has already taken from the company X. The simple solution for this is, after having the account number, counter will simply ask for the policy number. In some cases, staff may ask further identity like date of birth etc, similar to traditional bankers when any body ask for an inquiry over the phone. When the staff confirmed the identity of the client then he can ask for what the query is. Alphabetical symbol can be used for each product in order to simplify the catalogue of the products that Mr. A has already taken out from the company. For life assurance L or for motor insurance M, or cheque book C, credit card for K or direct debit DB and if DB for telephone then DB.T, for gas bill DB.G, if instead of DB, the client uses cheque book, then C.T for telephone bill etc. In case of incoming money, just the policy number will be used, similar to traditional bank account number. For out going of money including withdrawal of cash by the client from the ATM, this single account can be used (Table 3.17). For cash withdrawal this is important. ATM will be connected with a main computer like the traditional ATM. The company X can set up its own ATM in its branches and agency offices as well as links with traditional ATM network, so that,

Mr A can withdraw money easily whenever he needs subject to availability of funds or credit zone limit. Now in the following Table (3.16) we can classified all the products taken by Mr. A.

Table: 3.16
Products range to be covered by the assurancebank

Banking type	Investment type	Life insure. type	Gn. Insurance type
Current account	Savings account	Pure life cover	Household insurance
Cheque book	Pension	Life and savings cover	Building insurance
Plastic card	PEPs	Linked life	Content insurance
Direct debit	Other savings	Accident & health	Motor insurance
Deposit taking	Annuity	Mortgage indemnity	Travel insurance
Personal loan	Share dealing		Credit insurance
Money transmission (internal & external) ²			Card protection

Figure: 3.2 Assurancebank model



² For internal like commany’s own products, i.e. monthly mortgage payment, insurance premium etc. and external payment like telephone bill, gas bill, council tax bill etc. either via Direct Debit or Cheque or phone banking.

Life type, investment type, banking type, and general insurance types of products will be underwritten in separate sections but all will have direct links with each other for harmonisation of products and for the protection of duplication and conflicts of products. After designing and approval of each of the products, these will then be transmitted to the central computer (Figure 3.2). The central computer will play an important role. This central computer will be connected with the front office as well as Direct Marketing (DM) section so that both can download products as necessary and to the requirements of customers. The DM will be used like current DM system, i.e. direct sale of products over the telephone or in some cases referred to front specialist office group.

The front office will usually have two groups, namely ordinary and specialist. The ordinary groups will deal all sorts of financial dealing like bank branch. If specialist advice is necessary the matter will be referred to specialist group who will be very easy to access almost stand by. The front office may be insurance companies' own banking branch or agency or brokerage office. But emphasise will be given to DM. For further details, please see the organisation chart in Figure 3.3.

3.6.2. PRODUCTS TO BE COVERED BY THE MODEL

3.6.2.1. LIFE ASSURANCE TYPE PRODUCTS

(a) Life assurance:

Just a pure life cover can be given as if this firm is a traditional life insurer. This life office may design life policy in such a way that it can give to customer the benefit of protection and at the same time saving. Thus, that the customer instead of being

interested in just traditional savings, can be interested in this product which will give both the benefits to the customer.

(b) Linked life:

Linked life cover can also be given to a customer. If customer qualifies for a mortgage product which is also life company's own product, can be given life coverage/indemnity against the mortgage value to this customer. The property for which the mortgage is sanctioned can also be given coverage with a building insurance. This building insurance policy can be the company's own or they can act as an intermediary for this building insurance. At the same time content insurance or household insurance cover can be given for the house being mortgaged with the company. So that this company is selling five (mortgage, mortgage indemnity, life, household, building insurance products) products at the same time with the same person to a same person. Scale and scope economies should exist in this case.

Accident and health insurance can also be sold in this way.

3.6.2.2. INVESTMENT TYPE PRODUCTS

(a) Pension product:

Since traditionally the insurance company 'X' as a life company, will have experience in selling pension products as a combination of coverage, it should minimise its administration cost and should sell relatively cheaply in the market. As the salaries/wages come to this firm, it is easy to chase the customer for pension. In this case, the firm will create a database for prospective persons' for pension products.

This data base will be created from the data already held the central computer on age, job type, whether the customer's employer run a pension scheme and whether it is adequate for the customer, sex, etc. Care should be taken that the customer is not forced if it is not necessary for him and if customer does not want it.

(b) The PEPs:

Insurance companies are now familiar with selling PEPs. So, this product will be distributed in the existing way or if necessary like pension method way mentioned above.

Similarly, annuity, and share dealing can also be introduced through this investment sub channel.

3.6.2.3. GENERAL INSURANCE TYPE PRODUCTS

(a) Motor insurance:

A significant number of households have motor car. Third party insurance is compulsory. So to the same person who has taken mortgage, life assurance etc. can be offered motor insurance. As most of the underwriting information is held for previous products it is easy to sell motor products over the phone. If this company or any of its group do not underwrite motor insurance, they still can act as an intermediary with minimum commission or in some cases without commission at all in order to not to say 'no' to a customer. Thus, customer can be satisfied. Though it does not sound nice as a trader, it should be remembered that the company should satisfy the customer to retain him as the customer giving money to the company for different related products.

(b) Travel insurance:

Travel insurance can be sold in a similar way. But some holiday companies require their own products or a product that of a similar standard to that holiday company. In this case, the company can standardise the product to be similar to that of the holiday company's insurance products. It even can set pre arrangements such that if a customer comes and shows their proof, this will be accepted, as most holiday company keep the options that if you can bring similar products they will not charge for insurance.

In the same way, mortgage indemnity insurance, building insurance, household insurance, credit insurance, and personal loan and card protection insurance can be designed and introduced to the production line.

3.6.2.4. BANKING TYPE PRODUCTS

(1) Current account and cheque book:

This is important for assurancebank. If the customer has already taken a life or a mortgage etc. products, he will be offered a bank account number for banking activities. This account will receive his wages/salary etc. It can be the other way round if the customer has already opened an account and requires further services like mortgage etc. He will be given a cheque book so that he does not need to go to a traditional banks to do banking. This cheque will be of similar standard to the current banking chequebooks. Through this chequebook the customer can write cheques to others according to his need. The customer should confirm that he has sufficient fund to clear the cheque, other wise the cheque will not be honoured. This is same as in case of traditional bankers. The only difference is if the customer have opened a life policy, as long as he run the policy the firm will not charge the cheque return fee. If

the customer has not taken the life policy, a small charge can be taken but must be significantly lower than the traditional insurer. Putting the condition (mandatory) of life assurance is that the firm will be able to sell an extra life insurance. The customer will buy this policy thinking that as I will not pay the cheque return fee, instead I will pay a small amount of premium for my life cover. Not only that if the customer take a life policy or a mortgage and his salary should come regularly to the firm from his employer, he will be given free banking facilities. Currently traditional banks give free banking facilities if the customer do not overdrawn. Other services should also be free like as direct debit for paying gas bill, electricity bill, telephone bill etc, but the firm will pay the bill only if there is sufficient funds including pre arranged credit zone limit (if the customer is qualify for credit zone limit. The qualification measure may be the similar of traditional banks).

(b) Mortgage:

This product was offered traditionally by the building societies. Later on banks were allowed to offer mortgage (for instance Barclays). Lately insurance companies have also become involved in offering mortgage products (for instance, General Accident). Insurance company X can offer this mortgage. As the big insurers have already in the market and now have already learnt the 'know how', this will be easier for them to extend. If the customer is not the customer of the current company and has applied for a mortgage, he can be given the mortgage subject to qualification. He can (at the same time with mortgage offer or after giving the mortgage) be offered other services like bank account, chequebook, insurance cover etc. Once he has been captured by any of the major products, other products also can be sold to him as he needs these products

and he will take these if he has not already taken these products from some where else.

c) Deposits:

To qualify to take deposits from the public, an insurance company needs authorisation from the authority to do banking activities. The requirement of minimum capital is no problem for large insurance companies. The requirement of 'fit and proper' person can also easily be found as there are large number of redundancies in banking industries due to mergers and reducing of branches. For instance, the merger between UBS/Credit Swiss has cost redundancies about 4000 employees.

However, once the authorisation is granted the legal requirement is done. One question needs to be addressed here that can an insurance company conduct banking business through the existing legislation of European countries? We will attempt to answer this question later on in the next section. Another question is whether insurance companies need banking authorisation for conducting distribution of banking business (not underwriting banking business)? To find out this, we quote an example: In the UK, supermarkets like Tesco, J. Sainsbury etc. conduct banking activities to their own retail customers without having authorisation from the central bank or from the appropriate authority. What they do is to make a tied alliance with an established bank, and sell their banking products. Regulators have not yet intervened in these activities. Insurance companies can acquire a small or medium size bank or can create their own having prior authorisation from the appropriate authority, usually from the central bank. If a suitable domestic partner is unavailable, a cross boarder strategy might be helpful to have a banking subsidiary. Now the established insurance company can back this new sister bank in order to expand the business with strong co-

operation as if it were a different section of the same office. If authorisation is not granted simply within the existing scope of business, still some sort of banking operation must be conducted.

(d) Direct debit/standing orders/chequebook:

Insurance companies receive lots of direct debits/standing orders/ as well as bankers cheques as the payment of insurance premiums and fees. Insurance companies on the other hands pay small claims maturity money or surrender money to customer by banks cheques. If they have their own cheque they can reduce the dependence on traditional banks. Thus, the insurance companies that are very big customer of banks, by withdrawing their support, will be a serious threat for rebel banks on one hand, and on the other hand can save account fees.

Personal loan can also be arranged, based on maturity value if he has a life insurance policy and/or just simply applying credit method of personal loan.

Figure: 3.3 Organisation chart of assurancebank

Figure

Organization chart of Assurancebank

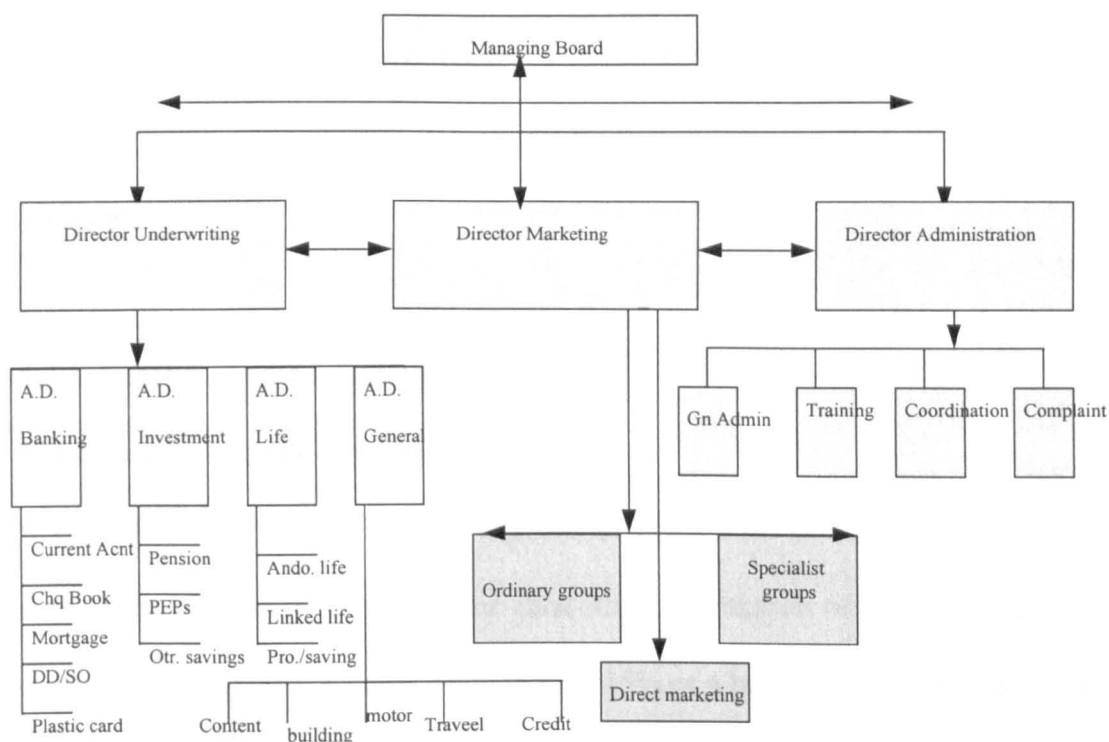


Table: 3.17
Assurancebank incoming and outgoing of money

Incoming of money	Out going of money
Wages/salary of customer	Mortgage payment to bank section (int)
Mortgage payment (internal incoming)	Payment of direct debit (int/ext)
Life premium (“ ”)	Clearing cheques (int/ext)
Motor etc. Premium (“ ”)	Cash withdrawal by plastic card
PEPs/pension payment (“ ”)	PEPs/pension etc. Payment (internal)
	Motor etc. Premium payment (“ ”)
	life etc. Premium payment (“ ”)

Table: 3.18
Human resources of assurancebank

Underwriter of all products	Distributor of all products	Management/training/feed back/complains
Life assurance type (each product is headed by one and his deputies)	General distributor (all type) Specialist distributor	Post service Managers for Banking, investment, life, & general to train/complain
Investment type (each product is headed by one and his deputies)	<i>NIL to save cost</i>	<i>NIL, thus save cost</i>
Banking type (each product is headed by one and his deputies)	<i>NIL to save cost</i>	<i>NIL, thus save cost</i>
General insurance type (each product is headed by one and his deputies)	<i>NIL to save cost</i>	<i>NIL, thus save cost</i>

3.6.3. VALIDITY OF THIS MODEL

For the validity of this model, the regulatory examination and a bankruptcy test is conducted.

3.6.3.1. REGULATORY EXAMINATION

i. Individual European Countries

The United Kingdom is traditionally liberalised. There is no restriction for UK market for cross shareholdings, or owning or controlling or creation of holding companies. But any person taking a holding of more than 15% of a bank has to submit his project for approval by the Bank of England. Prudential, Sun Life, have already taken a banking license from the Bank of England. France is one of the leading countries. For instance, AXA. insurance company is allowed to control banks or to create their own. Insurance companies in Germany can freely acquire shareholdings of banks by using their shareholders' funds, but can not own more than 10% of a company's capital through their technical funds. A 1925 law in Italy prohibits insurance and fund management companies from engaging in additional activities. From June 1991 insurance companies have been allowed to take shareholdings in banks. But the Bank of Italy retain the right to veto reciprocal shareholding arrangements. Insurance companies in Spain have been able to collect household savings since 1984. In 1981-89, regulatory barriers prevented banks and insurance companies from owning more than 5% of each other's voting stock. However, the Dutch Government eliminated the ownership barrier on January 1, 1990, thereby allowing banks to acquire control of insurers - and - vice versa- by creating holding companies. Banks and insurance

companies are permitted to own more than 15% of each other's share capital. Banks and insurance companies are allowed to own building societies and subject to certain conditions, vice versa since 1987. The legislation permits structural regroupings involving banks and insurance companies through the creation of holding companies (for instance ING Holding) which allow each entity to retain its autonomous management structure. In Sweden following the changes of law in 1991, insurance companies are permitted to hold + 5% of a bank or a financial institution subject to the supervisory authorities approving the holding and a number of key ratios, based on shareholders' funds, being satisfied. Insurance companies are free to adopt any group structure. Following the amendment to the Insurance Supervisory Act 1990, insurance companies in Denmark are able to conduct banking activities through their subsidiaries. Since 1 January 1992, an amendment to the law has permitted the creation of financial groups in Norway. Banks can own insurance companies and insurance companies can own banking companies.

ii. The EC Directives

Article 61(2) of the Treaty of Rome provides that 'the liberalisation of banking and insurance services connected with movements of capital shall be in step with the progressive liberalisation of movement of capital'. On the basis of this, the EC merger regulation came into force in September 1990. A merger falls within the EC merger regulation if it has a 'Community dimension'. The regulation does not define what is meant by a 'dominant position'. But The EC Court of Justice has defined dominance as 'a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on a relevant market by affording it

the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of its consumers’.

In order to decide whether a particular company does enjoy dominance, it is necessary to define the relevant market and then to assess the company’s strength in that market.

Insurance companies and banks are treated as a special case under the merger regulation. The value of gross premiums written is the basis of assessing the turnover of insurance companies, while one-tenth of total assets of a bank is used to assess the ECU five billion criterion.

Transactions involving insurance companies will have a Community dimension where:

- the combined value of gross premiums written by the groups concerned world-wide exceeds ECU 5000m; and,
- each of at least two groups concerned has gross premiums written with European Community residents of a value exceeding ECU 250m, unless of the groups concerned receives more than two thirds of its gross premiums from the residents of one member state.

Under the EC merger regulation, certain mergers, take over, and joint ventures within the EC countries require to be notified to the Commission within a specified time limit. After receiving the notification, the Commission will consider whether or not the proposed merger is compatible with the Common Market. In the course of its consideration the commission has extensive powers to require companies to submit to an investigation at their premises and to provide all the information required by the commission to enable it to carry out its investigation. If a merger ‘creates or strengthens dominant position as a result of which effective competition would be

significantly impeded in the Common Market or in a substantial part of it', then it must be declared incompatible with the Common Market. In such circumstances, the proposed merger may not proceed. In some cases the Commission may be prepared to approach a merger only if the parties agree to modify terms of the merger. In addition, the commission may attach conditions to any such approach and may impose restrictions, 'directly related to and necessary to the implementation of the concentrations'. If the merger regulation is applicable, the national merger laws of the member states need not be considered.

Insurance companies by merging with banks or securities companies may create problems for regulation and supervision. Because for such an amalgamation it is very difficult to assess a company's financial position by the regulators and supervisors as to whether the company is in safe and sound condition as different regulators and other problems. The EC has identified the following problems in particular:

1. the difficulty of assessing the financial position of a regulated entity in isolation from unregulated entities within the same conglomerates
 2. the difficulty of assessing the adequacy or otherwise as a conglomerate's capital, specifically if there is double-gearing;
 3. the effects of intra-group exposures; and,
- contagion, i.e. the risk that financial difficulties encountered by an individual company within a group could have an adverse impact on the financial stability of the group as a whole.

These issues were also addressed in the Tripartite Group Report.

On the initiative of the Basle Committee on Banking Supervision, a tripartite group of bank, securities and insurance regulators was formed in early 1993 to address a range

of issue relating to the regulation of financial conglomerates. Their report was sent to the Basle Committee, the Technical Committee of the International Organisation of Securities Commission (IOSCO), and the International Association of Insurance Supervisors (IAIS) in 1995 for their consideration. Following the Tripartite Group Report, the groups established a joint forum to develop practical working arrangements between the different regulators of financial conglomerates.

The commission established an expert group after a joint meeting between banking and insurance regulators on financial conglomerates in 1994. The groups mandate was to discuss the difficulties concerning the regulation of financial conglomerates and to address the different methods of dealing with the problems identified.

The expert group's conclusion is included in the following points³: consolidated supervision, double gearing/capital adequacy, intra-group transactions. The expert group considered a number of ways of excluding or identifying regulatory arbitrage by:

- applying the large exposure limits for credit institutions and investment firms on a solo plus basis to the entire financial conglomerate;
- monitoring the observance of large exposure limits according to the rules of credit institutions at a solo plus level, but as a 'warning test' only, which would not trigger any regulatory remedies; and,

applying the banking rules to the entire financial conglomerate if it is predominately banking and the insurance rules if it is predominately insurance.

³ Details are reported in Chapter four of this thesis.

3.6.3.2. THE RISK EFFECT OF THE ASSURANCEBANK MODEL

Measuring risk effect is an empirical issue. We will test this in Chapter six where the return and risk effects of insurance companies' diversification into banking business will be tested. If the test find risk reduction, this will support our model.

3.6.4. BENEFITS FOR ADOPTING THIS MODEL

- From Regulators side
 - Single regulatory authority for cost saving.
 - Easy co-operation and co-ordination on information flow allowing easy supervision as currently the regulators and supervisors from both side, i.e. banking as well as insurance, face the same problem. The UK government introduced this in 1997, named the Financial Services Authority (FSA) who will supervise banking as well as insurance and other financial services industries.
 - Reducing risk by allowing diversification
- **From Consumers side:**
 - every thing under one roof
 - time saving for customer
 - easy to keep financial record
 - cheaper
- **From Insurers side**
 - keep existing insurance customer
 - attracting banking customer
 - cost savings
 - increasing business
 - opportunity of profit making

3.6.5. POSSIBLE PROBLEMS OF THIS MODEL

- Regulators may think there is too much risk. Specially they are concerned about Bankruptcy risk. This will be tested in Chapter six.
- Too complex for keeping accounts for customers. But once it can set up/programme, this become very easy and time saving of staff.
- Dependence on central computer. This is now true in all sorts of business due to technological development and business virtually relies on it.
- Requirements of banking technical knowledge and training for insurance staffs. This problem can be solved easily by providing internal and/or external training or in some cases to have readymade one from the traditional banking human resource market.
- customers' attitude and preference may be negative about putting all the eggs in one basket. But research has shown that customer now want everything under one roof.
- clash between underwriting risk and loan and credit risk. As individual product qualify for it own merits, we believe there will be no clash. Instead due to diversifying of products, it spread risk, and thus should reduce risk.
- risk of fraud attempt. Due to the technological development like PDQ terminal, fraud can be prevented.

3.6.6. LIMITATIONS OF THIS MODEL

- This model should not be adopted initially for corporate customer level.
- The model will suit most of those who have regular income among the personal customer base.

- upto a certain amount of loan/credit should be given those who can be covered through this model.
- large exposure like aviation or marine risk should not be taken within this model.

We believe if this model is adopted, the fundamental problem of insurance will at least partially be solved, i.e. the insurance products will be purchased rather sold.

3.7. CONCLUSION

In this chapter, we have examined insurance companies' movement into banking business. To the best of our knowledge, this is first such examination ever. Here, we have also developed an assurancebank model and have tested its validity by examining a regulatory examination. The bankruptcy test of this model will be tested in Chapter six.

CHAPTER FOUR

REASONS FOR BANCASSURANCE AND ASSURANCEBANK

4.1. INTRODUCTION

In this chapter, we will investigate the strategic motives for changing the interface between the banks and the insurance companies. Traditionally bankers are bankers, and insurers are insurers. Bankers can not enter into insurance business, and insurance companies, on the other hand, can not enter in to banking business because banking business is regarded as a risky business, and insurance business too is regarded as a risky business. The basic business of a bank is to take money as deposit from the public; money transmission services; and, the lending of money. On the other hand, the basic business of an insurance company is to take risk against financial loss. But in Europe the situation is changing [Dickinson (1997)]. Banks can enter into insurance business, and insurance companies can enter into banking business. This cross-business activity has broken down the long separation of banking business from insurance business and vice versa. Therefore, the main question we address here is what are the driving forces that have motivated diversification into such risky activities, and on what ground the European regulators have abolished the long tradition of separation between banks and insurance companies.

The rest of this chapter is as follows: in section 2, we investigate the strategic motives for bancassurance and assurancebank, and in section 3, we conclude.

4.2. STRATEGIC MOTIVES FOR BANCASSURANCE & ASSURANCEBANK

There are a number of motives for bancassurance and assurancebank activities. These motives differ with regard to the parties involved in the diversification move. Entering into another industry is not an easy matter. There are several obstacles. Porter (1980) stated seven major entry barriers for entering into another industry. These are- government policy, economies of scale, access to distribution channels, products differentiation, capital requirements, switching costs, and cost disadvantages independent of scale. First five promote entry and the rest two restrict entry mode. In the whole process of bancassurance and assurancebank (these two terms are discussed in Chapter two and three respectively), there are four major parties. These are banks, insurance companies, the regulators, and finally the consumers. Therefore, to find out the reasons for bancassurance and assurancebank, we need to analyse each of the party's motives.

4.2.1. BANK MOTIVES FOR DIVERSIFICATION INTO INSURANCE

Hoschka (1994) studied the motives from the banks' viewpoint. He considered from two broad angles, namely firm level factor, and industry level factor. In firm level factor, he considered the following driving forces. These are (i) synergy effects; (ii) economies of scale; (iii) economies of scope. In the industry level factors, he considered the following factors: Demographic changes, economic environment, savings trends, differential tax

treatment, growth performance and potential, and insurance penetration and saturation. However, most of the authors frequently described the potential existence of economies of scale and economies of scope in the bank diversification into insurance business. Among these authors the notables were Dickinson and Dinenis (1992), Grant (1992), OECD (1992), Walter and Saunders (1994), and Kane (1994). Hardwick (1997) and Dinenis and Jung (1998) find the economies of scale and scope of the UK life assurance industry.

A. Economies of Scale and Economies of Scope

Dickinson and Dinenis (1992) mentioned that the economies of scale exist if per unit or average production costs decline as output rises. The traditional concept of scale economies in the single product firm refers to the behaviour of total costs as output expands, and economies of scale are said to exist if total costs rise less proportionately than output. When a firm experiences increasing returns to scale, monopoly is a 'natural' outcome of market forces. Any firm supplying the entire market can price so as to undercut any firm supplying part of the market.

Economies of Scope arise if two or more products can be jointly produced at a lower cost than is incurred in their independent production. Samuelson (1966) defines jointness in production as the ability of one firm to produce a given level of multiple outputs at a lower cost than a series of separate firms each specialising in the production of a single output. This property has been re-defined by Panzar and Willig (1981) as economies of scope. Specifically, there are economies of scope over the production of goods X and Y if

$$C(x,y) < C(x,0) + C(0,y)$$

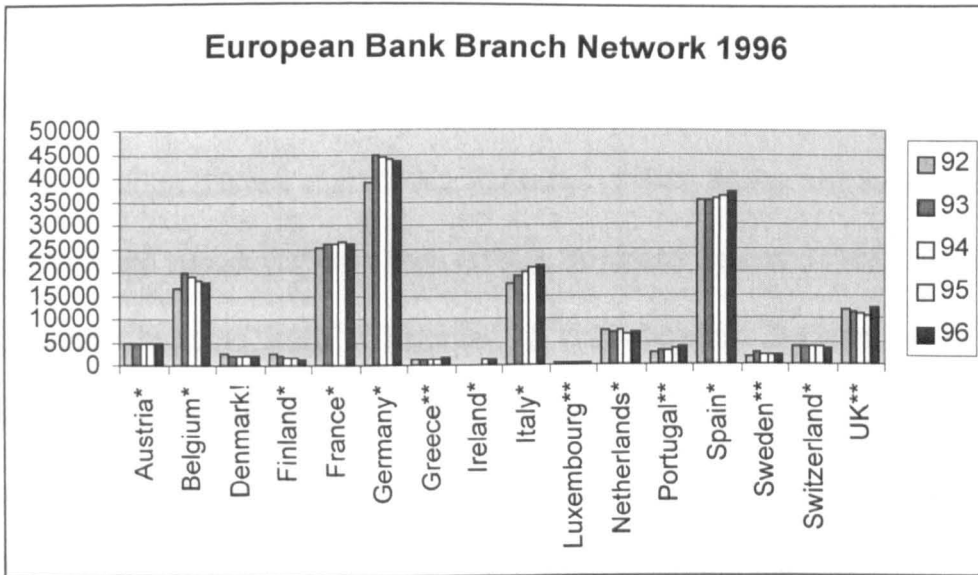
where $C(x,y)$ are the firm's (minimised) costs of producing x units of good X jointly with y units of good Y at a given vector of input prices. The effect of scope economies can be measured by

$$SE = \frac{C(x,0) + C(0,y) - C(x,y)}{C(x,y)}$$

SE is bounded from above by the value of 1 if marginal costs are non-negative (or if there is free disposal) so that the total costs of separate production can not exceed twice the cost of joint production. In the presence of scope economies, firms with diversified product mixes will tend to have total costs lower than the total costs of firms with specialised product mixes, for comparable levels of output.

Willig (1979) suggests that economies of scope arise from inputs that are shared or utilised jointly without congestion. It might be expected that this interdependence is especially prevalent in the banking industry. Insurance activity especially insurance brokerage can use the same factors of production as the main banking activities such as the existing capital stock/branch networks (Graph 4.1), branch personnel (Table 4.1) and data processing facilities. Joint use of general brand name advertising is also a source of economies of scope.

Graph: 4.1



* = All banks; ** = Commercial banks; ! = Commercial and saving banks.

Source: OECD 1998

Table: 4.1

Number of Bank Employees (x 1000) in Europe 1992-1996

	1992	1993	1994	1995	1996
Austria*	70	68.9	71.2	71	71
Belgium*	76	76.3	76.2	76.5	76.9
Denmark!	52	50	49	47	44
Finland*	38.9	36	34.1	30.6	27.1
France*	425	406.1	409.2	407.7	404.2
Germany*	709	717	724	724	716
Greece**	37.1	37.5	39.6	40.3	43.1
Ireland*	n/a	n/a	n/a	33.3	32.3
Italy*	337.3	340	338.5	337.5	327
Luxembourg**	17.6	18.5	19.7	20.1	20.6
Netherlands*	119.9	115.4	109	111.4	115.9
Portugal**	63	61	61	60	60
Spain*	253	247	246	245	242
Sweden**	284	37.2	39.1	39	39
Switzerland*	118.5	117.1	116.5	115.1	115.1
UK**	401.2	371.7	386.5	382.7	414.8

* = All banks; ** = Commercial banks; ! = Commercial and saving banks

Source: Compilation from the OECD 1998

B. Reducing risks:

According to portfolio theory, diversification spreads the risk, and thus reduces the risk. The banks by diversifying into insurance business may reduce their risks because of asset diversification [Brown et al (1996); Esibabies (1994); Walter and Saunders (1994); Boyd, Graham and Hewitt (1993); Ofeck (1992); Boyd and Graham (1988)]. On the other hand, insurance business itself is regarded as risky business because of the nature of its activities. Unexpected huge amount of claims may lead to bankruptcy. Rumelt (1974) argued that related diversification is beneficial and unrelated diversification is harmful. The banks diversification into insurance business may fall within the related diversification and therefore could be beneficial. Banks and insurance companies have a number of similarities. Maycock and Ravel (1976) identified the following similarities:

- 1.) Both banks as well as insurance companies are within financial industries group.
- 2.) Both involve in invisible and finance related trade.
- 3.) Both take money directly from individual public banks as deposits and insurers as premium.
- 4.) Both invest money in different long-term and short-term securities and bonds.
- 5.) Both have a huge number of client bases.
- 6.) Both are highly regulated industries.
- 7.) Both give peace of mind banks as safe keeper and insurers as risk taker.

Such similar characters justify the characters of relatedness and should support the diversification into insurance business. However, Llewellyn (1994) argued that if the probability of failure is decreased the diversification should be allowed, while if the seriousness of failure is increased the diversification should be limited. Therefore, this is an empirical issue and will be tested in Chapter five.

C. Product dependence

Some banks' products are correlated to insurance products. For example, Credit Insurance, Mortgage Indemnity Insurance, Marine Insurance, Mortgage Interest Insurance, Employers Liability Insurance, Life and Pension Plan for banks staffs etc are frequently taken by banks. Such product dependence may influence banks to diversify into insurance. From the banks' standpoint, Wood (1993) mentioned five products that bank frequently take out from the insurers. However, there are many more on which banks are dependent on insurance companies. From the banker's side, the following insurance products are frequently taken-out:

(i) Financial institutions insurance: -

A bank may demand this product from an insurance company to protect itself against criminal activities where the bank itself may be a victim. Such an insurance product may cover a loss arising from the dishonesty of an employee, a loss arising from forgery or counterfeiting or an armed raid on a vehicle carrying cash or valuable securities or even on the banks itself.

(ii) Credit insurance: -

There are many types of credit insurance. A bank may take this insurance via bankers customers or directly by itself as assignee by complying with the requirements of section 136(1) of the Law of Property Act 1925 and section 50 of the Marine Insurance Act 1906. Cover is provided against losses arising as a result of the default or insolvency of a borrower in the case of a bank lending money on the security of the property or assets. It

also arises in relation to trade receivable in the form of credit and export credit insurance which cover losses arising from the default or insolvency of a buyer of goods or services from the bank's own customer.

(iii) Mortgage indemnity insurance: -

A bank may take this policy directly as insured as an assignee of its customer or via the customer. The risks insured against and losses covered are commonly the shortfall arising on the sale of the bank's security in the form of property, where a bank exercises its power of sale under its security arrangements or in the event of default by the borrower under a mortgage, or foreclosure, or where a property is the subject of a compulsory purchase order, demolition or clearance order or closing order or blight notice affecting the value of the property.

(iv) Marine insurance: -

A bank might come across this type of insurance as part of a package of security where it has advanced money against the security of goods shipped aboard or where it has lent money against the security of a ship, under a ship mortgage, or against freight payable. This insurance will cover specified perils associated with maritime adventures such as perils of the seas, fire, war perils, piracy and barratry.

(v) Mortgagees interest insurance: -

A bank may have a customer to whom it has advanced money on the security of the assignment of the proceeds of a policy of insurance and where the customer fails to disclose the material facts to the insurers. This may entitle insurers to avoid the contract

of insurance in its entirety, leaving the bank, through no fault of its own (other than its choice of customer) unable to recover under the policy. For this some insurers provide a bank with insurance, on payment of a premium by the bank, to cover the risk of the failure of the primary insurance taken out by the bank's customer in specified circumstances.

(vi) Interest rate and liquidity risk: -

Life insurance companies assist banks to manage interest rate risk, either directly through purchasing long dated, fixed-rate debt issued through the capital markets or through direct placements, or indirectly by taking positions in swap and in other financial markets. Again when banks have sought to increase the liquidity within their asset portfolios by securitizing their non-tradable loans, life insurers have often purchased the bonds issued from this process [Dickinson & Dinenis (1992)].

(vii) Loss of earnings insurance: -

There are additional forms of insurance that a bank sometimes requires an owner to take out. Here a part of the security is the assignment of a time charter and in certain cases political risks insurance. Banks are looking such policies more frequently these days [Dickinson & Dinenis (1992)].

(viii) Employers liability insurance: -

This is compulsory insurance under the Employers Liability Act. Besides, banks' directors and officers are taking directors and officers liability insurance to provide cover

for defence costs as well as the amount of compensation for which directors may be liable to pay when courts hold them personally responsible for their negligence in operating the company.

(ix) Life and pension plan for bank employees: -

Banks arrange special terms for life assurance for their employees with a sum assured as being payable in the event of death of an employee during his term of service with the bank or in the case of pension at the time of retirement.

Some common products of bankers and insurers are shown in the table to indicate their dependence. Bankers-insurers dependencies are discussed more in chapter one.

Table: 4.2

Some Products Dependence on Banking and Insurance		
Bank products		Insurance products
Bank account		Financial institution insurance
Cheque, direct debit etc		Credit insurance
Letter of Credit		Mortgage insurance
Foreign exchange dealing	→	Mortgage indemnity insurance
Mortgage	←	Marine insurance
Loan		Employers liability insurance
		Life and pension plan for employees
Investment management		

Source: own compilation

D. Other incentives of bank diversification:

(i) Managers secret deal:

During the sixties, the traditional insurance agents used to visit banks branches hoping to get prospects for potential customers, recommended by branches. When many of the agents started requesting bank managers for potential prospects, specially related to banks

products (for instance, Letter of Credit) the managers saw many requesters. Different agents tried to influence managers to get the business. Some went a little further. They started offering share of commission. Bank managers realised that this is a good source of income, and they were referred more bank customers to these agents to get some extra money as commission in addition to their salaries. In this way, these managers were working as sub-agents of the insurers. Soon after, this is late sixties and early seventies, this secret deal became an open secret. This news spread to senior level. Then senior managers also saw that this is a potential source of income, they officially recognised this, and started up their own insurance brokerage firms. (*reported in Chapter two*). Banks managers were asked to refer all sorts of insurance business to these broking subsidiaries. Now the commission goes to the bank's pocket instead of going to the banks managers' pocket.

(ii) Disputes over insurance:

Banks with their banking products take out insurance for their clients as an assignee. Some times it is seen that policy cover does not come in time which is very important in this competitive market. Sometimes banks do not find suitable insurance products from insurance companies, which they need to match with their clients' requirements. Not only that some times there are disputes over the claims and claims settlements. This disputes damage customers faith towards banks as well as leading to financial losses (e.g. *Banques Bruxelles Lambert v. Eagle Star, Banque Financiere de la Cite S.A. v. Westgate Insurance Company Ltd*). Banks believe that insurers try to wriggle out of their obligations by relying on technical legal arguments (utmost good faith etc.) and small print. Insurance

companies also feel that the banks try to dump on them some of their disastrous losses, which arise purely out of bad lending. Such disputes gave them the idea to find an alternative idea of business.

(iii) Customers' frequent visit to banks:

Customers more frequently visit banks branches than the insurance agencies. Almost all sorts of business and day to day life involve contact with bank directly or indirectly. These vary from household telephone bill to shares and investments. When customers come to the branch for investment advice or for a car loan or mortgage or other sorts of credit facilities, then it is very easy to attract these customers at that moment for insurance. This helps banks in two ways, as an extra product line of business which gives extra profit, and a protection for the banks when it grants different types of credit like loan, Over Draft (OD) facilities, or mortgage for house purchase. So, for banks, it is easy to get in touch with the prospective customers to sell insurance.

(iv) Banks' managers as key advisers:

Most people take their financial advice from their banks' managers at first hand. As the bank managers know the customer's financial condition better than any one else, so he/she can give the best advice to the client. Besides, the bank managers themselves have an image to the customers. Bankers can use such an image for insurance selling.

(v) Declining profit of traditional current accounts:

Bankers traditional current account, which is one of their core activities, is no longer a profitable business. To survive, insurance expansion may be a good one.

(vi) Directors attitudes to be too big:

Bigger firms do not always want just to maximise profitability and/or potential scale/scope economies. There are some other reasons as well. For instance, banks directors may wish for high social status and prestige, and to acquire more bargaining power [Dickinson and Dinenis (1992); Dickinson (1994)] at government and industry level. Business directors always want to be giants. Then they can have more bargaining power, more independence, and at the same time can have enjoyed scale/scope economies in the firm. Like a colonial government they can expand their activities into other business areas such as insurance and can hold a greater position.

(vii) Diversified attitudes:

One of the most important characters of banks is their diversified attitude (discussed in Chapter two). They now extend far from their core business. The core activities of a bank are to take deposits from public, lending of money and money transmission services. Now a days, in addition to these core activities, they offer a wide variety of financial products. Securities dealing, foreign exchange dealing, mortgage lending, pension fund management etc. are not originally banks products, but banks have been offering these products for a long time. Diversification into different areas of business is a long tradition of banks. Now the time has come, after the removal of regulatory barriers, to diversify into insurance, which has already been started. They now claim 'what banks should not be'.

(viii) Profit maximisation:

Every profit making business has the target of maximising profit. Traditional current accounts are no longer a profitable business. Moreover, allowing building societies to offer core-banking products has brought high competition in the market. Some times it is

too difficult to survive. If banks introduce another product line like insurance, then this new product line may give extra income to the bank that will maximise the profitability of the business. For instance, 30% of the TSB’s group profit came from insurance in 1994. This has attracted other competitors to diversify into the insurance area.

(ix) Governments withdrawal support on pension:

After the deregulation of financial services in the late eighties, the governments in different European countries have encouraged personal pension plans, and, thus, have decreased government support in pension sectors. In the UK, the governments pension expenditure to the GDP was 7% in 1985 and was decreased to 4% by 1995. Similarly, in Germany the expenditure was 12% in 1995 and was decreased to 10% in 1995.

Table: 4. 3

Pension assets in the EU 1997			
Country	Value of assets \$bn	Assets as % of GDP	Assets per capita \$000
Italy	133	10	2.3
Sweden	196	177	2.2
Germany	360	16	4.4
France	168	11	2.9
Belgium	26	10	2.5
Finland	39	31	7.6
Spain	17	3	0.4
Portugal	9	10	0.9
Denmark	136	76	25.9
Netherlands	482	121	30.7
UK	862	72	14.6
Ireland	26	38	7.2

Source: EU Pension Provision, Mintel ‘98

From the table 4.3, we notice that top three countries contribute more than 70% of the pension market. Other EU governments (for instance, Italy) including the EC (for Pension Fund Directive) are reforming the pension plan. Therefore, this will be an attractive area into which banks can diversify. The Second Banking Directive has already permitted banks to offer pension products. Mintel (1998) reported that bancassurance companies have already gained control 20% of the life and pension market within the EU.

(x) Motto of financial supermarket:

In the modern world, customers want everything in one place for their shopping in order to save time and hassle. This is a dramatic change for customers' attitudes and habits. That's why the superstores are doing better day by day, and the specialist shops are declining rapidly. The changing habits of customers influence financial shopping as well. People want their insurance, investment, mortgage, loan, etc. from the same place without going different places. In a recent survey, carried out by Swiss Re [Sigma (1992)], showed that the customers prefer their financial products 'under one roof'. Responding to customers changing habits and attitudes, the banks are now changing their name in the branch offices. For instance, instead of using 'Barclays Bank', or 'National Westminster Bank', or 'Midland Bank' or 'Halifax Building Society' as they used to use before, most of the branches are now simply using 'Barclays', 'Natwest', 'Midland'(HSBC), and 'Halifax' respectively. This means they are no longer only a bank but a universal financial institutions for all sorts of the financial products.

4.2.2. INSURANCE COMPANY MOTIVES FOR DIVERSIFICATION INTO BANKING

Insurance companies' motives in engaging banking business is of defensive type due to banks' heavy involvement in insurance activities and, at the same time of potential existence of economies of scale and economies of scope like the banks (discussed earlier). For instance, agency networks, policyholders database, common advertisement etc. may have potential scale and scope economies. Hardwick (1997) found the scale and scope economies in the UK ordinary life assurance. Dinenis and Jung (1998) also found the scale and scope economies in the UK life assurance industry. In addition to potential scale and scope economies, there may be other motives of diversification by the insurance companies. A study, by Precepta (1991), described the insurance companies' motives of diversification from three different angles. These are:

- (1) The threat of new entrants, i.e. banks, savings banks that are competing with insurance companies for a greater share of people's savings.
- (2) Socio-economic factors, i.e. increasing wealth of the European economies, higher personal disposable income, the accumulation of more assets to insure, demographic changes, and the increasing financial literacy of the population.
- (3) Governmental factors, i.e. particularly declining governmental role in the provision of social security benefits.

Diacon (1990b) showed nine areas of advantages for the insurance companies' linkage with banks. These are:- (i) access to banks' customer base; (ii) lower marginal costs in generating new business; (iii) cost allocation method; (iv) banks' better image; (v) easy

exploitation of cross-selling; (vi) better post-sales service because of physical presence; (vii) useful distribution medium for insurance; (viii) utilisation of capital-intensive operation; and (ix) downstream vertical integration to secure distribution. From the European context, we can further investigate the driving forces from the insurance companies' viewpoint.

(i) Counter respond to bank:

As we have mentioned earlier, the banks in Western Europe are moving into insurance activities. These banks are moving not only into insurance distribution activities but also into the core activities of insurance, i.e. underwriting of insurance business. This is regarded as a serious threat to insurance companies. The insurance companies now have to compete not only with their traditional libel insurers but also these new entrants who have a very strong branch network channel and financial backing as well as a better image in the general public's mind. Due this better image and other incentives, the banks' market share in insurance distribution is increasing dramatically. For instance, in 1995, the life assurance market share by the European banks were as follows:- France 56%, Germany 15%, Italy 19%, Spain 35% and Netherlands 15%. *(Further details are shown in Chapter two)*. Even in underwriting activities they are increasing their market share day by day. Insurance companies have taken this as a great threat to their future survival. That's why, the insurers believe that they should also be involved in banking activities as a counter response. Some big insurance companies have already started banking operations. This is reported in Chapter three.

(ii) Product dependence:

Insurance companies, frequently take banking products. For instance, banks do not offer Letter of Credit, which is one of the main statutory instruments for international trading, unless an insurance policy is taken out against it. This can be done directly by the banks as an assignee or via bank's customers. To diversify into insurance business reduces dependence on insurance companies. Some of the dependent products are discussed in the following sub-sections.

(a) Bank account: -

To establish an insurance firm, whether it is underwriting or broking, a bank account is required by the company's law. Insurance firms have to notify to the regulator the details of the company with whom they will bank. In this respect, insurance firms are dependent on banks for this service. Insurance companies are dependent on banks not only for themselves but also for their customers. For instance, Read (1974) reported that the insurance companies make pension payments regularly to some three million pensioners (in the UK) and they do so by cheque by and large. Only about half of those pensioners have bank accounts. Therefore, the insurance companies by paying pension payments in the form of cheques, makes the pensioners obliged to ask a favour of the grocer at the corner to cash.

(b) Bank and Building Society cheques: -

The insurance companies' customers commonly use Banks and Building Societies' cheques to pay the insurance premiums or brokers fee.

(c) Direct debit:

This is a more advanced method where there is a regular premium payment schedule. A direct debit is a pre arranged system of payment between the customers (insured) bank and the seller’s (insurers) bank to collect premiums having been instructed by both their bankers.

One study indicates how strong bankers and insurance company’s traditional relationships were. About two decades ago Read (1974) pointed out the insurance industry’s share of the UK market for money transmission in 1972. Insurance companies in the United Kingdom in 1972 accounted for 60% of all bank direct debits and 51% of all bank standing orders. Some of his illustrations are shown in the 4.4.

Table: 4.4

Insurance industries share in money transmission services			
	Insurance companies		Total number Numbers of items in millions
	Number	% of total	
<i>RECEIPTS</i>			
Bank cheques	40.3	2.0	1654
Bank standing orders	47.8	51.0	94
Bank direct debits	32.4	60.0	55
Cash (items over 50p)	368.0	3.0	11238
<i>PAYMENTS</i>			
Bank cheques	32.9	1.9	1642
Bankcredit transfers	2.8	1.3	211
Bank standing orders	1.4	1.4	94

Source: Read (1974)

(d) Insurance companies staff’s salary and commission: -

There are a huge number of people working in insurance companies. Their salaries and commission are paid through banks or through cheques, which make them bound to open a bank account for this purpose.

(e) Foreign exchange dealings: -

Most of the banks provide a foreign exchange advisory service. This is important for insurance companies particularly those who conduct their business internationally. This service is particularly important in the international reinsurance market. Banks by providing such services can assist insurance/reinsurance companies in minimising exchange exposure. In this way insurance companies can improve on most money transmission times and thus interest-earning potential for all premium flows. Atkinson (1975) reported this, which was later cited by Maycock and Ravel (1976).

(f) Investment: -

Insurers have two types of fund to invest. One is shareholders fund, and the other is policyholders fund. Shareholders fund is gathered by selling insurance companies shares like any other registered companies. The policyholder funds are gathered from the premium income. This fund is invested for meeting the future claims because the money the insurance companies take from the customers as premium is too small to meet the claims. On the other side, the sum of the small amount of premiums from the individual is huge. Insurance companies can give this money to banks for investment, so that the insurance companies can get investment return and banks can have extra money to lend or to keep for day to day banking activities necessitates by their vast client demands.

(g) Short-term lending: -

Banks provide short-term loan to insurers whenever required for their day to day banking business.

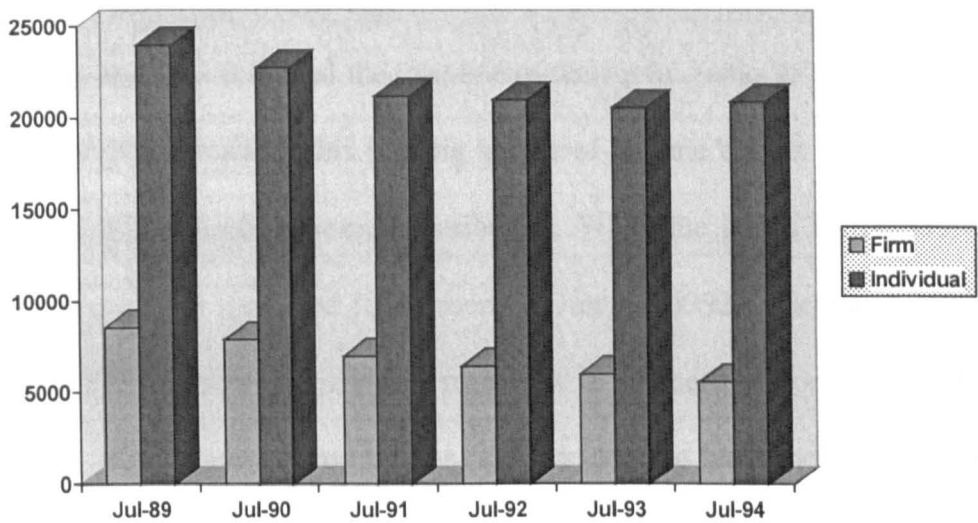
Therefore, such product dependence may influence insurance companies to diversify into banking activities.

(iii) Decreasing of traditional insurers brokers channel:

The Brokers channels are declining rapidly (*shown in graph 4.2*) due to the bankers heavy involvement in insurance distribution. In 1989, firms and individual brokers were 8550 and 24000 respectively, which declined by 1994 to 5570 and 20900 respectively. The brokers can not cope with banks in the insurance distribution race as the banks have huge customer base with country wide branch network and a strong financial backing. Moreover, people are more interested in one stop financial shopping rather (mentioned earlier) than specialist sources, and thus these brokerage channels are declining rapidly. On the other hand, the banks are withdrawing their support for distribution of insurance from the traditional insurers. So, insurers are losing two very strong channels (brokers and banks). For this reason, establishing a bank will give them a strong channel of insurance distribution as well as expansion of financial products. Diacon (1990b) mentioned four long-term strategic implications for declining independent intermediaries. Firstly, it will become difficult for insurers to offer a wide product range because it may not be cost effective to have specialised sales staff dealing with a subset of the full range. Secondly, price and quality based competition will be less important and sales will be more dependent on image, advertising etc. Thirdly, disturbance of innovation and finally,

if the competition is on size-based advantages then the market is more vulnerable to competition from the much larger EC and international companies.

Graph: 4.2 Declining of insurance brokers channel



Source: FIMBRA/Whitaker '94

(iv) Banks and Building Societies withdrawing distribution support:

Banks and Building Societies started offering insurance to their banking client bases in the late sixties. A very few banks started by offering insurance products with their banking products. These insurance products were not manufactured by the bankers. These were made by traditional insurers. Banks began to make strategic alliance with traditional insurers on the condition that insurer will underwrite and bankers will just distribute the insurance products in return for commission. Insurance companies by keeping their traditional channel added a very strong new channel i.e. bank channel, in their

distribution network. Thus, the insurance companies were getting huge amount of businesses from banking channel, and they were offering special commission rate. In this way, both parties were getting benefits from each other for this co-operative interface. Banks were getting extra sources of income as commission, and insurance companies were getting an extra huge source of business from a single source. Other banks and Building Societies followed the example of their rival banks to retain their market share. Soon, the banks realised this is a big source of income almost without bearing any risk and they emphasised insurance distribution. When the banks learnt 'know how', their bargaining power increased [Dickinson & Dinenis (1992); Dickinson (1995)], and they were demanding more as now they were now in a better position compared to other sales channel. Some started going further. They decided to have their own insurance outlets. Having their own insurance outlet, they then started distributing their own insurance products and terminating strategic alliance with traditional insurers. In some cases, they bought all or significant amount of equity share of that allied companies. For example, Halifax Building Society, by terminating its agreement, set up its own insurance company in 1995. This is called Halifax Life Assurance Company. Similarly, Bank of Scotland started acquiring Standard Life's equity holdings (34%). For this reason, the insurance companies are moving towards banking to fill up the gap.

(v) Synergy effects:-

Synergy exists when $2+2=5$. Insurance companies by using their agency network and insurance agents, brokers channel to the huge number of policyholder clients, and getting customers database from the policy forms through IT network can use scale and scope

economies. Economies of scale exist if average production costs decline as output rises, i.e. banking products. On the other hand, economies of scope arise if two or more products can be jointly produced at a lower cost than is incurred in their independent production [Panzar and Willig (1981); Samuelson (1966)]. In economic term,

If x is insurance product; and y is banking products, then economies of scope exist if

$$C(x,y) < C(x,0) + C(y,0).$$

With the insurance products agents/brokers can sell banking products to their clients. This way they can cut the unit cost and can sell products relatively cheaply if they engage into banking business as well. Details are discussed in earlier section of this chapter.

(vi) Expand of financial products:-

In the business literature, there is a simple strategy that on demand 'no' should be minimised. Especially in personal sector of business, sellers keep a wide range of products, assuming that if customers come for one item may take another item. Insurance companies by entering into banking area can expand their product line. People coming for insurance products may take banking products as well. Hardwick and Dou (1998) also stated that insurance companies, which develop new marketable policies and other products, give themselves an immediate comparative advantage in the production of those products.

(vii) Decreasing dependence on banks:-

Every insurance company has to have a bank account to start up a business with. This is required by company law. Moreover, staff salaries, agents' commission, and claims payment, etc. go through banks. Much of the premiums come to insurance companies through direct debit and/or cheque account. Both are banking products. Insurance companies by setting up their own bank can reduce dependence on banks and they can get rid of paying fees/charges etc. to banks. Or by entering into foreign exchange market, for instance, insurance companies can handle their own international claims settlements or transferring premiums into local currency. In this way, they can get rid of paying commission to banks and reduce dependence on bank.

More importantly, money gathered, as premiums from individuals are huge. Most of this money is given to banks for long and short-term investments for capital gain. Insurance companies have to meet the claims if they occur in the future, and the money they receive as premium is not sufficient to meet the claims. In most of the long term insurance policies insurance companies give bonus to policyholders. It may be said that insurance companies have two sources of income, one from premium income and the other from investment income. This investment consists of shareholders fund and policyholders fund (in technical term life fund for life assurance companies). Insurance companies by setting up their own investment banks can do investment banking and make more money. Now a day most of the insurance firms have their own investment banking/fund management subsidiaries.

(viii) Retain existing customers:-

Banks are offering wide range of products, i.e. banking products, building societies products, and insurance products. Banks are offering different incentives to its customers for switching off their other financial products from other providers. For example, mortgage, insurance etc. Since the bank managers are regarded as key financial adviser to customers, these managers may influence bank customers in buying other financial products, and in that case at least some of the insurance customers may go to the banks. Therefore, to retain these (existing) customers, the insurance companies should be in the position to offer similar facilities. And to do this they need a banking licence. Moreover, we have mentioned earlier that the customers attitude and habits are changing (*Swiss Re 1992*). People want everything from one roof. If customers do not get all the products from his insurers he may change his insurer and may go to other who offer all the products he needs, i.e. banking as well as insurance products.

(ix) Profit maximisation:-

Profit is the main target for the traders (except charities and few others). By expanding into new line of business there is a chance of maximising profits. Insurance companies' profitability has decreased during the last ten years or so [Dinenis & Verkati (1996)]. So entering into banking business could be profitable. Or if even not profitable, it can be substitute to insurance in different ways as discussed above. We can draw a bank example. 30% of TSB's total profits in 1994/5 came from insurance business. In the following table we reported other European banking companies' insurance contribution to

banking profitability. This may be the same when insurance companies enter into banking.

(x) Reducing risk:-

The insurance business itself is regarded as risky business because of the nature of its activities. Unexpected huge amount of claims may lead bankruptcy. The insurance companies, by diversifying into banking business, can reduce risk because of asset diversification like the banks (discussed earlier section of this chapter). According to portfolio theory, diversification spreads the risk, and thus reduces the risk. Therefore, to reduce risks, the insurance companies may diversify into banking business. However, this is an empirical issue and will be tested empirically in Chapter six.

(xi) Cross-border entry facilities within the EU:

Through a series of banking as well as insurance Directives the European market is more liberal than ever and anywhere in the world. These Directives give power to EU nationals to set up business anywhere in Europe. This is called single passport for business. Banks or insurance companies existing in one country can set up their branch in other EU countries without prior authorisation from the host country. They are even free from host country control, but they are controlled by the home country authorities. This gives an idea of cross-section activities between banking and insurance. How does the strategy work here? For example, one big bank of one European country can buy a smaller local insurance company in another EU country or arrange joint ventures or simply make a strategic alliance with another insurance company. On the other hand, one big insurance

company in one EU country can acquire a smaller bank in other EU country. The logic behind this is to enter into each other's market [Dickinson & Zajdllic (1994); Dickinson (1997); Hardwick and Dou (1998)]. Thus, the European liberalisation through 'single licence' within the member states motivates banks to move into insurance and vice versa. We have shown such cross-border entries in the Table 4.5.

Table: 4.5
Banks-insurance cross-border links in Europe, 1996

Bank	Insurer	Venture formed
Banco Popular Espanol (UK)	Allianz (Germany) and its Italian subsidiary RAS	joint venture life company
Abbey National (UK)	Winthertur (Switzerland)*	Joint venture ABBEYCOR to market endowment mortgages
Caser, the Spanish insurance company of CECA, the saving bank confederation	Skandia (Sweden)	Joint venture life company, Intercaser
Spanish subsidiary of BNP (a leading Franch bank)	Generali (Italy)	Joint venture pensions management company
Banque Indosuez (France)	Mapfre Vida (Spain)	Joint venture Mapfre Indosuez
Banco Atlantico (Spain)	AGF Espana (subsidiary of AGF France)	Joint venture company, AGF Atlantico
R+V (Germany)	Cajas Rurales (Spain)	Rural Vida and Rural Seguros Generales
Banesto (Spain)	AGF (France)	Agreement to set up a 50%/50% insurance company for products distributed through Banesto
Monta del Paschi di Siena (Italy)	Predica (France)	Joint venture life and non-life company
ICCRI, the central institute of Italian saving banks	AXA-Midi (France)	Joint venture life company
Credito Italiano (Italy)	Commercial Union (UK)	Distribution agreement and local cross-shareholdings
CARIPLO (Italy's largest savings bank)	TSB (UK) and CNP (France)	Joint venture life
ING Group (Netherlands)	Bishopsgate Insurance Co (UK)	Acquisition
Delta Lloyd (Netherlands)	Commercial Union (UK)	99% of CU's subsidiary
Baltica Group (Denmark)	Hambros (UK)	10% of Hambros
Forties	WSB bank	

Source: own compilation from various sources

4.2.3. THE EUROPEAN REGULATORS MOTIVES

4.2.3.1. THE EUROPEAN REGULATORS MOTIVES FOR ALLOWING DIVERSIFICATION

Traditionally the banking and insurance industries have operated under different laws and regulations, which implied separate supervisions. The banking business is mainly regulated by the central bank of the country (Table 4.6) and the government's trade department mainly regulates the insurance business. (Table 4.7). There is a strict legal barrier, so called 'Chinese Wall' between banking and insurance industry. Banks can not own insurance companies, and on the other hand, insurance companies can not own banking companies. Even in insurance business life assurance companies can not own general insurance companies and general insurance companies can not own life assurance companies¹.

(i) The Need for Regulation

The basic function of a bank is of taking deposits from public, lending of money and money transmission services, on the other hand, the basic function of an insurance company is to take risks against financial loss [discussed in Chapter one].

These two industries are regarded as the two core pillars of the whole financial system. The country's economy is mainly based on them. Banks take money directly from the public in two ways: One is by selling shares, debentures etc. like other registered PLC companies and the other is by taking money as deposits. Insurance companies also take money directly from the public in two ways. One is by selling shares, debentures etc. and

the other is taking insurance premiums against specified risks. So, we see that both of them take moneys directly from public and conduct their business with public moneys.

To evaluate the need for regulation, it is necessary to highlight the banking and insurance market structure. In the banking and insurance market there are (1) manufacturer, i.e. banks and insurance underwriters, (2) suppliers, i.e. different intermediaries like branch network, agents, brokers etc, and (3) consumers, i.e. policyholders and depositors. Some specialist market place are designed like stock market, future market, foreign exchange market, insurance exchange market (Netherlands only) to conduct different financial business operations. All the parties mentioned above thus are directly involved in the operation process in the market and every party in the process is dependent on each other to complete the whole business process. The government has responsibility to protect all the parties involve in the process as well as to protect the market in order to maintain a sound and smooth financial operation to stabilise the economy. Government through its financial watchdogs or regulatory agencies protects all the parties and the market by using various regulatory and supervisory tools.

However, there is a debate in the market economy as to whether the regulation is unnecessary because it hinders the efficient operation of markets [Rahman (1992)]. In the market economy, the market will decide who will stay, and who will not stay in the market in a competitive environment by allowing 'caveat emptier'. In a competitive market, those who perform better will survive and those who do not will be automatically out of the market. In case of banking and insurance, the situation is different since both conduct their business with public money one as deposits and other as premiums. So, it is

¹ One may argue on the composite companies, i.e. that offers both life as well as non-life cover. But even

the government's duty to protect such depositors and policyholders savings. Carter and Dickinson (1992) in the banner of 'barriers to trade in insurance' identified the following objectives for regulation from the insurance companies' perspective. These are protection of policyholders, avoidance of wasteful and destructive competition, development of local insurance market, protection for balance of payments, channelling funds to local capital markets and national security. On the other hand, from the banks' perspective, Meier (1991) identified the following objectives: to monitor corporate solvency, to ensure fair trading to regulate entry to markets, to promote price stability, and to satisfy social objectives. Therefore, it is seen that the regulation in banking as well as in insurance broadly serves a common goal, i.e. (1) Protect the public money, (2) Safeguard the economy, (3) Control the economy. Brady et al., (1995) in their regulation theories also justified these reasons.

(ii) The Rationale for Keeping Separation of Banking and Insurance Business

Banking business is regarded as a risky and complex business; insurance business is also regarded as a risky and complex business. This can be seen by observing the huge volume legislation and regulation for insurance and banking businesses. Keeping separate these two risky and complex business will reduce the complexity and risk. Also keeping them separate will stop them from becoming a giant financial firm that may manipulate the business and economy. Dickinson and Dinenis (1992) argued that the prohibition of cross business activities between banks and insurance companies has existed in order to reduce the vulnerability of the financial system and to minimise the potential growth of power by

composite companies have to operate under two different section life and non-life business.

large financial conglomerates. For this reason, almost every jurisdiction has deliberately kept separate these two businesses through prohibitive regulation. Furthermore, insurance companies accounting system and banks accounting system are totally different. The firm's financial positions and risks are assessed from the accounting system by the regulators and supervisors². By keeping them separate it is easy to assess each groups risks and financial strength to obtain an overall picture. Since banking and insurance businesses are both based on paramount faith by the public as if a bank or an insurance company goes bust, then the depositors or policyholders will lose their savings. This will then have a negative effect on the survival of other companies because the public will loses faith in them. People will withdraw their deposits or close their insurance policies. From this will result a shortage of capitals and in this respect the economic system of a country may collapse.

(iii) The Reasons for Abolishing Restrictions by the European Regulators

As we mentioned earlier, bankers can not invade insurer territory and insurers on the other hand, can not invade bankers' territory. There is a Chines Wall between them. Because the law does not allow such cross activities. But why are the regulators and supervisors in Europe now liberalising legal barriers between banking and insurance business, while in the rest of the world, including other very strong and open economy likes the US, Japan, Canada still keeping banking firms separate from insurance firms. In this respect, Europe may be used as a laboratory or a test-field for the possibility of

² There is a requirement by the regulators and supervisors of banks and insurance companies that banks and insurance companies have to submit financial statements, prescribed by the regulatory authorities from where they can assess individual company's risks and fitness.

‘financial supermarket’ for others. There are good reasons for liberalising legislation’s and regulations in Europe. This is the direct effect of the formation of the EEC that is based on the Treaty of Rome of 1957. The purpose of the EEC was to create a ‘common market’ for a greater integration within the European countries. The European regulators have liberalised the market for (a) creating greater competition in the market so that customers can get competitive lower prices and better quality of services; (b) integrating and harmonising the market to achieve the ‘single market’ theme in Europe; and more importantly (c) decreasing bankruptcy risks (this will be tested empirically in chapter five and six) by allowing diversification.

In the modern world, customers habits are changing³. People want everything from under one roof including banking products as well as insurance products⁴. There are also business trends, which we see these days. For instance, tobacco companies own insurance companies⁵. Airlines own insurance companies⁶, clothing stores are entering into banking⁷ business, groceries stores are entering into banking⁸ and so many cross section activities are developing. This trend has also influenced banks and insurance companies to diversify into each other’s territory.

Technology has been improved dramatically, especially since the seventies. Information can be sent more efficiently and faster than ever before. Laptop, mobile telephone, Internet, and modern telephone system have made it easier to transfer messages. Banks

³ Hoschka (1994) ‘Bancassurance’ in Europe.

⁴ This is supported by a recent survey on banking customers with regard to bancassurance.

⁵ Eagle Star insurance company is owned by BAT industries, a tobacco company.

⁶ Virgin Atlantic.

⁷ Marks and Sponsors in the UK.

and insurance companies by using these technologies can spread their business with efficiency.

Risk management tools have also been improved. Sophisticated high tech has allowed financial companies to assess risks efficiently and thus minimise risks⁹. Instead of traditional option and future market, high standard derivative instruments have been implanted in the financial markets. Trade and business are becoming more internationalised by the day. This has also given an influence to liberalise markets.

As trade and business are increasing day by day financial company's business volume are also increasing. The more and more increasing business the more dependence to each other companies, i.e.. Banks to insurance companies, or vice versa. A substantial amount has to be paid for taking the services that provide that. As banking and insurance businesses are co related in the business world, banks or insurance companies can reduce dependence by setting up their own outlets if legislation allows them to do so. Moreover, due to a common market theme from the Treaty of Rome (1957), cross-border strategy can easily be applied, i.e. large banks in one member state can acquire small insurance companies to enter that insurance market and thus have a direct pressure to regulators to liberalise the market.

⁸ Tesco superstore, J. Sainsbury in the UK.

⁹ For instance, PDQ terminal for fraud cards transactions.

4.2.3.2. TRADITIONAL REGULATORY & SUPERVISORY SYSTEM OF BANKING AND INSURANCE: AN OVERVIEW

Traditionally the banking and insurance industries have operated under different laws and regulations, which implied separate supervisions. The banking business is mainly regulated by the central bank of the country (Table 4.6) and the government's trade department mainly regulates the insurance business. (Table 4.7). Therefore, there are different regulatory frameworks for banking and insurance. These regulatory frameworks are based on legislation's and further regulations to cover up the 'A to Z' of the whole business process, i.e. authorisation process, scope of business, capital requirements, solvency margin, suitability of directors and managers, accounting rules, monitoring intermediaries, protection of depositors and policy holders, and winding up process of business. Within the respective regulatory frameworks, there is a strict legal barrier, the so-called 'Chinese Wall' between banking and insurance industry. Banks can not own insurance companies, on the other hand, insurance companies can not own banking companies. Even in insurance business life assurance companies can not own general insurance companies and general insurance companies can not own life assurance companies¹⁰.

There are a great variety of regulatory and supervisory systems that differ from country to country in Europe. This differences are in the insurance business as well as in the banking business because of the nature of different jurisdictions and country's economic system

although the EC has harmonised these system among the Member Countries by introducing a series of insurance and banking directives (discussed later in this chapter).

However, in Europe two basic models are generally distinguished in insurance. *On going supervision* which is mainly followed by the UK and Netherlands, and the *comprehensive material supervision* which is mainly followed by Austria, Switzerland and Germany. Other countries in Europe follow the mixed forms [e.g. Hohlfeld (1993)]. In banking too the UK and the Netherlands are regarded as having the most liberal regulation while Germany and others are regarded as strictly regulated. Whatever the methods used, traditionally the banking and insurance regulation and supervision are conducted separately by the separate regulatory and supervisory institutions. This argument is supported by our preliminary investigation results in Table 4.6 and 4.7.

¹⁰ One may argue on the composite i.e. that offers both life as well as non-life cover. But even composite

Table: 4.6
Overview of European banking legal system

Country	Main Banking Laws	Central Bank	Regulators & Supervisors	Main Banking Association
Austria	The Banking Act 1979 (amended 1986)	Oesterreichische Nationalbank (1922)	Fachverband der Banken und Bankiers	
Belgium	The Banking Law 1935	Banque National de Belgique (1850)	The Banking Commission, Banque National de Belgique, Institut Belgo-Luxembourgeois de Change	Association Belge des Banques
Denmark	The Commercial Bank and Savings Bank Act 1975 (amended 1985)	Danmarks Nationalbank (1936)	Finanstilsynet	Den Danske Bankforening
France	The Banking Law 1984	Banque de France (1800)	Commission Bancaire	Association Francaise des Banques
Germany	The Banking Law 1934 (amended 1961, 1974)	Deutsche Bundesbank (1957)	Federal Banking Supervisory Office, Ministry of Finance, Deutsches Bundesbank	Bundesverband Deutscher Banken eV
Italy	The Banking Law 1936	Banca d'Italia (1893)	Banca d'Italia	Associazione Bancaria Italiana
Netherlands	The Act on the Supervision of the Credit System 1952 (amended 1956, 1978), The Credit Control Act 1976	The Netherlands Bank (1814)	The Netherlands Bank Ministry of Economic Affairs	Nederlands Vereniging van Banken
Portugal		Banco de Portugal (1846)		Associacao Portuguesa Bancos
Spain	The Banking Law 1962, 1988	Banco de Espana (1922)	Banco de Espana	Consejo Superior Bancario
Sweden	The Banking Law 1969 (amended 1987)	Sveriges Riksbank (1897)	Bankinspektion, Ministry of Finance	Svenska Bankforeningen
Switzerland	Federal Law on Banks and Savings 1934 (amended 1971, 1972, 1976,1981)	Schweizerische Nationalbank (1906)	Federal Banking Commission	Schweizerische Bankiervereinigung
United Kingdom	The Banking Act 1987, The Financial Services Act 1986, The Building Societies Act 1986	Bank of England (1694), The Registerer of Friendly Societies	Bank of England, Securities and Investment Board	British Bankers Association, Building Societies Association

Source: own compilation from various sources

companies have to operate under two different section life and non-life business.

Table: 4.7
Overview of European insurance legal system

Country	Main Insurance Laws	Regulators and Supervisors	Main Insurance Association
Austria	The Insurance Supervisory Law 1978 (with amended upto 1986)	Insurance Supervisory Authority (Ministry of Finance)	Verband der Versicherungsunternehmungen Österreichs
Belgium	The Belgian Insurance Act 1975, The Insurance Companies (Regulation) Decree of 1976	Insurance Control Office	Union Professionnelle des Entreprises d'Assurance
Denmark	The Insurance Companies Act 1959 (revised 1981), The Insurance Contract Law 1930, The Marketing Act 1975	The Insurance Council, Financial Supervisory Service (Ministry of Industry)	Assurandor Selskabet
France	The Law of 13 July 1930, The Law of 26 July 1992, The Law of 4th January 1994.	Insurance Directorate (Ministry of Economy, Finance, and Budget)	Federation Francaise des Societes d'Assurance, Union des d'Assurance et de Capitalisation par Actions du Secteur Privee
Germany	The Law for Insurance Regulation 1901, Insurance Business Law 1983 (amended 1984)	Federal Supervisory Office for Insurance	Gesamtverband der Deutschen Versicherungswirtschaft eV
Italy	The Insurance Industry Law 449 1959 for Life, Law 990 1969 and Law 45 1981 for motor, Law 295 1978 for Property and Liability and Law 14 1978 for annual return	Ministry of Industry, Trade, and Crafts, Istituto per la Vigilanza sulle Assicurazioni Private e di Interesse Collettivo	Associazione Nazionale Imprese Assicuratrici
Netherlands	Supervisory Insurance Business Act 1987	Insurance Commission	Verbond van Verzekeraars in Nederland
Portugal		Portuguese Insurance Institute, Ministry of Finance	Associacao Portuguesa de Seguradores
Spain	The Insurance Control Law 1969, The Laws of 2 February 1912 for regulating insurance companies, the Law of 16 December 1954 for regulating private insurance	Insurance Supervisory Service (Ministry of Finance)	Union Espanola de Entidades Aseguradoras, Reaseguradoras y de Capitalizacion
Sweden	The Insurance Business Act 1982, The Anti-Trust Act 1953	Swedish Private Insurance Supervisory Service	Svenska Forsakringsbolags Riksförbund
Switzerland	Federal Law on Insurance 1895 (revised 1978)	BfV	Schweizerische Versicherungsverband
United Kingdom	The Insurance Companies Act 1982, The Lloyd's Act 1982, Financial Services Act 1986	Department of Trade and Industry (Insurance Division), Personal Investment Authority	Association of British Insurers

Source: own compilation from various sources

A recent survey on banking and insurance by the OECD (1992) within the OECD countries shows that European countries have the most liberalised cross-sectional activities between banking and insurance of all countries. In some countries, underwriting activities are relatively restricted while the distribution activities are very liberalised. This is shown in the table. This study did not show the exact laws that allows for cross activities and the exact time period from when the regulators in Europe have liberalised the cross section activities. In our own investigation in 1996 we have filled in this gap. We have shown which laws of the individual European countries have allowed cross-sectional activities between banks and insurance companies, from when, and in what capacity i.e.. directly or by setting up a subsidiary etc. This is reported in Table 4.8.

4.2.3.3. ABOLISHING RESTRICTIONS BETWEEN BANKS CHANGING POSITION IN INDIVIDUAL EUROPEAN COUNTRIES

Europe was the first mover in the changing patterns between banking and insurance, especially Western Europe. The UK was the first mover in such cross-section activities. TSB (1967) became the model, which was later copied by other European firms, though Barclays Bank started this operation two years earlier than TSB. Here, we will investigate the development of changing laws and regulation country by country in European countries with regard to banking - insurance cross-section activities, i.e. '*bancassurance*' and '*assurancebank*'.

i. The United Kingdom (UK):

Under the Insurance Companies Act all insurance companies must be authorised to carry out insurance business. Insurance business is divided into long term and short term. Each

is divided into classes following the classification into first life and non-life directives. The second and third life and non life directives have been implemented into the UK law by regulations amending the Insurance Companies Act and by revoking the Insurance Companies Regulations 1981 and replacing them with the Insurance Companies Regulations 1994. Amendments were also made to Insurance Companies (Credit insurance) Regulations 1990, the Insurance Companies (Amendment) Regulations 1992 and the Insurance Companies (Accounts and Statements) Regulations 1983. This changing approach is to follow the EC Directives wordings and to adopt a liberal approach where there is a choice. The United Kingdom is traditionally liberalised. There is no restriction in the UK market for cross shareholdings, or owning or controlling or creation of holding companies. But a person acquiring a holding of more than 15% in an insurance company is regarded as a controller of that company and is then subject to the obligation to report the proposed acquisition to supervisory authorities for approval. The UK is the first mover with regard to bancassurance. Although the term '*bancassurance*' is a French word, in the UK in 1965 the largest commercial bank and one of the then world largest banks, Barclays PLC, set up its own life assurance subsidiary, named Barclays Life Assurance Company, a life underwriting company. Two years later in 1969 TSB set up its own life assurance subsidiary, named, TSB Life Assurance Company, a life underwriting company of the bank. The TSB is now called the model of bancassurance. 30% of TSB's group total profit comes from insurance. But after the implementation of The Financial Services Act 1986, such cross-section activities increased dramatically.

All the commercial banks and major building societies now have their own life assurance subsidiary. The Building Societies Act 1986, also allow building societies to offer most

of core commercial banking products i.e. cheque book, current account etc. and to own life assurance underwriting companies. For distribution of insurance UK banks have a long tradition of distribution of insurance. Almost all the commercial banks have their own insurance broking subsidiaries. From 1994 onwards building societies were free to acquire general insurance underwriting companies if they so wish. On the other side, any person taking a holding of more than 15% of a bank has to submit his project for approval by the Bank of England.

ii. France:

France is one of the leading countries where banking insurance commercial interface appears to have developed significantly. In France *bancassurance* operation started from mid 80's. Banks are allowed to control insurance companies or to create their own. At the same time insurance companies are allowed to control banks or to create their own. The first bank entered in insurance was Federales Vie in 1969.

iii. Germany:

In Germany bankers-insurers cross section activities also started in the late 80s. Banks have to notify the Federal Control Office and the Bundesbank when they plan to acquire of more than 10% in an insurance company. Insurance companies can freely acquire shareholdings by using their shareholders' funds, but can not own more than 10% of a company's capital through their technical funds. Although the regroupings of banks and insurance companies started in the 80s, in 1992 the Raidheisen Co-operative banks started selling both life and non life insurance products on behalf of their subsidiary, R + V Allgemeine, which in 1922 was ranked as the second largest company for non-life business and the 4th largest for life business.

iv. Italy:

The 1936 Banking Act prohibits banks and special credit institutions from owning insurance companies. A 1925 law also prohibits insurance and fund management companies from engaging in additional activities. From June 1990 banks are permitted to acquire insurance companies and from June 1991 insurance companies have been allowed to take shareholdings in banks. But the Bank of Italy retains the right to veto reciprocal shareholding arrangements.

v. Spain:

Although insurance companies have been able to collect household savings since 1984, the banks could not directly offer insurance products until the Act of 30 April 1992 and had to set up their own brokerage firms. Banks can now negotiate distribution agreements with insurance companies.

vi. Netherlands:

Between 1981-89, the regulatory barriers prevented banks and insurance companies from owning more than 5% of each other's voting stock. However, the Dutch Government eliminated the ownership barrier on January 1, 1990, thereby allowing banks to acquire control of insurers - and - vice versa- by creating holding companies. Banks and insurance companies are permitted to own more than 15% of each other's share capital. Banks and insurance companies are allowed to own building societies and subject to certain conditions, vice versa since 1987. The legislation permits structural regroupings involving banks and insurance companies through the creation of holding companies (for

instance ING Holding) which allow each entity to retain its autonomous management structure.

vii. Belgium:

Banks are permitted to take control of insurance companies, subject to authorisation from the Financial and Banking Commission. Banks can create their own insurance companies, run insurance broking and set up Joint-Ventures, as long as they do not infringe the limitations imposed on the investments of their liabilities to policyholders.

viii. Sweden:

Following the changes of law in 1991, insurance companies are permitted to hold + 5% of a bank or a financial institution subject to the supervisory authorities approving the holding and a number of key ratios, based on shareholders' funds, being satisfied. Banks have to meet the same requirements as these imposed on insurance companies. Unlike insurance companies, which are free to adopt any group structure, banks may only be subsidiaries of others banks, insurance companies, or holding companies. However regrouping of banks and insurance companies have already taken place in Sweden.

ix. Denmark:

Following the amendment to the Insurance Supervisory Act 1990, insurance companies are able through their subsidiaries to conduct banking activities. Banks are not permitted to have qualified shareholding in a company, which exceeds 15% of their shareholders' funds. The total amount of 'qualified' shareholdings of a bank must not exceed 60% of their funds. These restrictions do not apply to subsidiaries of banks if these are either credit institutions or insurance companies. Insurance companies are allowed to create banking subsidiaries, and vice versa.

x. Norway:

Since 1 January 1992, an amendment to the law has permitted the creation of financial groups. Banks can own insurance companies and insurance companies can own banking companies.

xi. Portugal:

Portuguese legislation neither prohibits nor explicitly permits the distribution of insurance products by banks. Now almost all the commercial banks offer insurance products.

Table: 4.8

Cross-business permissible activities in Europe

Feature	UK	France	Germany	Italy	Spain	N.Lands	Denmark	Belgium	Sweden	Portugal	Norway
1. Legislative permission											
Bank	1986	1992		1990	1992	1990	1990		1991	*	1992
Insurance	1986	1992		1991	1984	1990	1990		1991	*	1992
2. Direct Production											
Bank	No	No	no	no	No	No	No	No	No	No	No
Insurance	No	No	no	no	No	No	No	No	No	No	No
3. Direct distribution											
Bank	Yes	Yes	yes	yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Insurance	Yes	Yes	yes	yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
4. Equity holding											
Bank	15%	10%	N/a	N/a	N/a	15%+*	15%+ but -60%	+5%	N/a	N/a	N/a
Insurance	10%	10%	N/a	N/a	N/a	15%+	15%+ but -60%	+5%	N/a	N/a	N/a
5. Creation of subsidiary											
Bank	Yes	Yes	yes	yes	Yes	Yes	Yes	Yes	yes	Yes	Yes
Insurance	Yes	Yes	yes	yes	Yes	Yes	Yes	Yes	yes	Yes	Yes
6. Creation of Holding											
Bank	Yes	Yes	yes	yes	Yes	Yes	Yes	Yes	yes	Yes	Yes
Insurance	Yes	Yes	yes	yes	Yes	Yes	Yes	Yes	yes	Yes	Yes

*Portuguese legislation neither prohibits nor explicitly permits cross section activities between banks and insurance companies. N/a

= Not available.

Source: Own compilation from various sources

4.2.4. CONSUMER MOTIVES

The consumers also influence diversification, especially banking and insurance cross diversification. The Swiss Re (1993) conducted a survey about the consumers' attitude towards insurance. The survey shows that 34% prefer to buy life assurance from sales man, 21 % from brokers, 18% from building societies, 15% from banks and 3% choose post as their favoured method. The banks and building societies combined account for $(18\% + 15\%) = 33\%$, which is one third of the national market. Such consumer preference has also influenced banks and insurance companies to diversify towards each other's activities.

Consumers by buying everything under one roof can save time and energy. They may possibly save cost by getting especial offer from a bank or from an insurance company (for instance, mortgage and building insurance from the same company). On the other hand, there is a proverb, 'do not put all your eggs in the same basket'. If all the saving elements are bought from the same company and if the company become insolvent or if there is any fraudulent misrepresentation in the contract then there is a risk of losing everything in that case. We will test the bankruptcy risk in chapter five and six from the bancassurance and assurancebank perspective respectively.

4.5. CONCLUSION

In this chapter, we have investigated the strategic motives with regard to changing interfaces between the banks and the insurance companies. In other words, we have investigated why the European banks are moving towards insurance activities and why the insurance companies, too are moving towards banking activities. We have

investigated these strategic motives from the bankers' point of view as well as the insurers' point of view. We have seen that the bank strategies are offensive type and insurer strategies are more defensive type. From the above investigations, we have seen that the changes of regulation are the crucial factor for changing interfaces between the banks and the insurance companies. The EC directives have also a great influence in changing their interfaces. It is believed that bank diversification into insurance or vice versa, will provide opportunities of risk reduction and cost savings. On the other hand, it is believed that such diversification will increase bankruptcy risks. Therefore, in the next two chapters, we will test bancassurance and assurancebank risks respectively.

CHAPTER FIVE

TESTING RETURN AND RISK EFFECTS OF BANKS DIVERSIFICATION INTO INSURANCE BUSINESS

5.1. INTRODUCTION

We have shown in Chapter two that banks have diversified into insurance business, i.e.. bancassurance activities, and in Chapter three that the insurance companies, have also made incursions into banking business, i.e. 'assurancbank' activities. The main objective of this chapter is to test the effect of European banks' diversification into insurance business, in particular, life assurance underwriting business, general insurance underwriting business, and insurance broking business on their risk and return. The main issue we deal with is whether the probability of bankruptcy decreases or increases. To the best of our knowledge, this is the first attempt to quantify the benefits of bancassurance in Europe.

Bancassurance may be potentially beneficial since it allows the commercial banks to diversify into insurance activities and diversification may spread risk and thus reduce the risk of failure. On the other hand, insurance activities may be riskier than banking activities when viewed on a stand-alone basis. If so, then *the 'bancassurance' firms* may increase the probability of bank failure.

The rest of this chapter is as follows: in section 2, we outline the alternative measure of risks. In section 3, we discuss the review of literature. In section 4, we develop the methodology and describe the data collection for the test. In section 5, we conduct the test and analyse the results. Finally in section 6, we conclude.

5.2. ALTERNATIVE MEASURE OF RISKS

Studies of the risk implications of insurance activities can be approached in three ways [Eisenbeis (1994)].

The **first approach** is descriptive examinations of the risks inherent in insurance and banking activities as compared with those found in banking generally. Various studies have attempted to characterise the risk and related attributes of insurance and to identify the kinds of synergies that might exist between traditional banking activities and insurance brokerage and underwriting [e.g. Maycock and Ravel (1976); Dickinson and Dinenis (1992); Walter and Saunders (1994); Eisenbeis (1995)]. Brokerage is mainly a commission and/or fee oriented business. It is not a capital utilising activity, and since the bank is merely acting as an agent, there are little safety and soundness concerns. However, the potential risks to the safety and soundness (or solvency risk) of a broking firm relates to: losses from its inability to sell enough policies, that is, to earn sufficient commissions to cover fixed and variable costs of operations; the potential opportunity cost of diverting scarce management resources toward an unprofitable area of business; and potential legal liability for errors and omissions made in marketing such policies. Nevertheless, brokerage activities have been typically profitable with high yields on invested equity (mainly in the form of incremental physical capital). For instance, in the

UK in 1996, out of the top ten profitable insurance brokerage firms, six firms were owned by bank.

Insurance underwriting, on the other hand, may pose some higher risks to those banks that seek to undertake the activity. Historically, the activity is capital intensive and profitability has typically been low (Arthur Yong 1983).

General insurance underwriting entails knowledge of specialised risks, most of which are not closely related to traditional banking activities. For instance, in general insurance underwriting, the key feature of claims loss is the actuarial predictability of losses relative to premiums earned, which banks are not familiar with. Banks are not even familiar with how to handle this type of losses. Walter and Saunders (1994) reported that the general insurance underwriting companies' insolvency risk may arise as a result of unexpected increases in loss rates, unexpected increases in expenses (legal expenses, commissions, taxes etc.), and unexpected declines in investment yields/returns. General insurance underwriting companies' underwriting profits are generally negative. Table 2.15 in Chapter two clearly shows how risky underwriting activities are. However, underwriting companies try to manage profits from their investment income.

Life assurance underwriting is less risky than general insurance underwriting, because the risks are more predictable. Nevertheless, profit levels have remained lower than in general insurance underwriting. The industry has been characterised by a rapidly changing product mix as whole life policies decline in attractiveness relative to other products. The largest growth area has been in annuity type products, which closely resemble longer-term bank CDs [e.g. Eisenbeis (1995)].

However, there are certain types of risks that are not fundamentally different in nature that banks typically undertake in their other activities. For instance, project risk

assessment and pricing of risks are everyday banking activities, as are hedging and investment activities to control exposure.

The **second approach** is event studies, i.e. by examining stock market data to determine if the announcement of intent to engage in insurance activities is perceived by the market to be a positive or negative event. In the market data, a risk measure is commonly used in the finance literature, one which can only be computed with market data. It is the beta coefficient of a firm's common stock, a measure of the relationship between the rate of return on the stock and the average rate of return to the market. Here, the beta is obtained by estimating the time-series regression.

$$R_j^m = \alpha + \beta(R_j^{sp}) + \mu_j$$

where R_j^m is the market rate of return on equity for j period, α is an intercept term; β is an estimate of the beta coefficient; R^{sp} is an estimate of the return to the total market, which is based on the value of Standard and Poor's 500-stock price index, P^{sp} :

$$\overline{R}_j^{sp} = (\overline{P}_j^{sp} - P_{j-1}^{sp}) / P_{j-1}^{sp}$$

and μ is an error term.

However, market data have their own problems. The volatility of market returns, for instance, may reflect random noise or at least some kind of exogenous shocks which are unrelated to the true profitability of the firm. No one as yet has satisfactorily explained why market returns are consistently as volatile as they are (Mehra and Prescott 1985). Market data also have a dating problem, which has been called look-ahead bias. Market prices have been found to respond to published accounting data. The publication date of financial data typically lags the

end of the reporting period by two or three months. Therefore, computing market returns based on stock prices for the same date as the end of the accounting period may imply that the investor is able to forecast without error (Banz and Breen 1986). Nevertheless, we were interested in using stock market data as well as accounting data, but we were unable to obtain market data for banks' own insurance subsidiary companies, as majorities of them are not reported separately in the market. Hopefully, other researchers may be able to employ stock market data in future whenever they are available.

The **third approach** takes a portfolio selection approach and attempt to determine, using returns from banking, insurance and other possible activities, whether insurance is likely to be risk reducing and whether it is found in the efficient asset set. Since we have managed to collect only accounting data, we will employ this approach in our risk/return analysis of bank diversification into insurance activities.

5.3. REVIEW OF LITERATURE

A number of US studies examined the potential portfolio implications of permitting banking firms to engage in different forms of insurance business. [Heggstad (1975), Wall & Eisenbeis (1984), Litan (1987)]. They have employed data from federal income tax returns which allow aggregate comparisons of the potential impact on return on assets over different time periods by examining the correlation between returns on non banking and banking activities, and the coefficient of variation of returns from non-banking business as compared with banking business. A lower coefficient of variation would suggest that the activities might potentially be risk reducing if permitted to banking firms or *vice versa* in the case of higher coefficient of variation. Litan (1987) calculated the coefficient of variation(CV) of returns for each industry and their correlation coefficient(CC) with

banking. He argued that mergers of banks and non-banks would be potentially risk reducing if the coefficient of variation for non-banking industry is small relative to banking, and if the correlation coefficient between banking and non-banking returns is negative. The results of some of the studies are shown in the table 5.1.

Table 5.1.

Results of some studies on risk effects of banks diversification into insurance business

Activity	Heggsted		John & Meinster		Wall & Eisenbeis		Litan (62-72)		Litan (73-82)		Litan (62-82)	
	CV	CC	CV	CC	CV	CC	CV	CC	CV	CC	CV	CC
Banks	.25		.33		.21		.23		.20		.22	
BHCs					.20	.79			.20	.63	.20	.63
Insurance underwriting					.18	.41	.18	-.79	.29	.23	.25	-.19
Life assurance					.10	-.40	.13	-.87	.32	-.04		-.27
Mutual insurance					.49	.31	.59	-.55	.41	.44		-.21
Other insurance					.43	.45	.18	-.46	.49	.36		.08
Insurance agency	.12	-.38	.15	-.42	.19	.70	.10	-.62	.23	.21		-.06

CV = Coefficient of Variation; CC = Correlation Coefficient.

Source: Litan 1987

Litan (1987) presents the coefficients of variation for return on asset (ROA) for pair wise combinations of banking and insurance agency and underwriting activities. In mutual insurance underwriting, the combined bank-insurance underwriting coefficient of variation (CV) of ROA is greater than for banking alone. The results suggest that insurance agency activities are less risky than banking if they had been permitted to banks. The returns on insurance underwriting for life assurance, mutual insurance, and other insurance were negatively correlated with those of banking, suggesting that in the

right proportions, had banks been permitted to engage in insurance underwriting activities over the period 1962-1982, their risk, on average, would have been reduced.

Litan (1987) reached a slightly different conclusion when efficient portfolio combinations of various banking and non-banking activities were considered using the Internal Revenue Service (IRS) data in a mean-variance framework. Banking clearly appears to be among the least risky activities - with low variance and mean returns. Insurance activities appear to be riskier. Insurance agency activities appear to be the most risky, but highest yielding, activity. Meinsten & Johnson (1974) reached similar conclusions.

Boyd & Graham (1988) employ accounting data rather than income tax data, to investigate the return and risk implications of expanding bank holding company activities. They use return on equity (ROE) to capture returns and two measures of risk. These two are the standard deviation of ROE and a measure of the probability of bankruptcy. Their data include information on insurance activities [life assurance underwriting; general insurance (property & casualty) underwriting; insurance agency activities], securities and, real estate activities. Their method was a simulation merger between banks and firms in these industries, and a comparison of the resulting bankruptcy risk measures for the simulated firms with those of unmerged banks. In their experiment, they found that bankruptcy risk falls slightly when banks merge with life assurance companies, but rises when banks merge with property/casualty insurance or insurance agent/broking or securities or real estate firms.

Profitability of agency (broking) and underwriting of general insurance business (property & casualty) exceeds that of bank holding companies, but all insurance activities looked more risky according to their measures. Simulating pair wise combinations of BHCs and various insurance activities, they found that ROE would have been slightly higher if

agency activities had been permitted and slightly lower if general insurance and life assurance underwriting had been permitted. However, risks would have been lower for bank combinations with life assurance and slightly higher if agency and general insurance activities had been permitted.

Another study by Boyd, Graham and Hewitt (1993) found that mergers of bank holding companies with life assurance or property/casualty insurance (general insurance) firms would reduce risk but with insurance agency/broking would have increased.

Wall (1987) found that the probability of failure is greater for non-banking subsidiaries than for banking subsidiaries. Liang and Savage (1990) found that risk is greater in non-banking than banking. In examining the potential impact on bank risk of permitting securities business, Kwast (1989) found that diversification gains were relatively small. Rosen *et al.*, (1989) also found minimal benefits.

Walter & Saunders [1994] conducted analysis of US banks diversification into different non-bank activities including insurance. They found that highest return per unit of risk would be obtained in the combination of banking with property/casualty insurance.

Brown, Genetay, and Molyneux (1996) further developed the Boyd and Graham model. They include UK accounting data to conduct a simulation study of banks and building societies diversification into life assurance. In their simulation, they found that building societies and mutual life insurers would be significantly risk reducing. But for other combinations like building societies with proprietary life, commercial banks with proprietary life, and mutual life, risk would not significantly change measured by standard deviation and covariance. However risk would significantly fall, measured by Boyd Graham's Z score method.

5.3.1. BOYD & GRAHAM (1988), BOYD *ET AL.*, (1993) METHOD AND SOME MODIFICATIONS

Our methodology in this test is heavily reliant on Boyd & Graham (1988), Boyd, Graham & Hewitt (1993) and further Brown *et al.*, (1996). Boyd & Graham (1988) conducted a test on the US banks' involvement in six different non-bank activities. These non-bank activities were property/casualty insurance, life insurance, insurance agent/brokers, securities, real estate development, and other real estate business. In the US, such cross-business activities are prohibited by the Glass-Steagall Act 1933, and therefore, they conducted a simulation merger analysis by developing a model of risk/return characteristics. First they analysed the risk/return characteristics of the various existing industries, using the data for 249 publicly traded bank and non-bank financial firms during 1971-1984. They captured the median rate of ROE as return measure, and standard deviation of median ROE and Z score (developed by them) as the two risk measures. Three variables, namely, the consolidated total assets, equity, and net income (after tax) are chosen for these measures. Based on these variables, they computed sample risk and rate of return statistics for each industry to look at the historical relative risk and return in these industries. They then conducted hypothetical mergers between banks and each of these non-bank industries and compared them with the banks to show the differences between the pre-merger and post merger results. Their hypothetical merger method is based on simple assumptions, i.e. simply the sum of the two individual firms' consolidated total assets, equity, and net income. In their hypothetical mergers, they randomly choose one bank and one non bank firm with replacement, and generate a time

series of returns and estimate return, standard deviation and Z-score for each hypothetical firm. For each type non-bank financial firm that the banks were merged with, 100 hypothetical firms - each with its own median return, standard deviation, and Z score – were obtained and thus created six new hypothetical industries. They then calculated (with the same procedure as in the pre-merger) the median rate of return and risks of these newly created hypothetical firms and compared them with the pre-merger results.

Boyd, Graham & Hewitt (1993) modified their previous hypothetical merger method. In 1993 analysis, they employed a scaling procedure in their hypothetical merger instead of using the *simple adding method*, and observed the effect at different *average* weighted level, i.e. from 10% to 99% level.

Brown *et al.*, (1996) applied the Boyd and Graham method in the UK life assurance industry. They captured mean return on assets (ROA) as return measure and three measures of risk, namely standard deviation, covariance, and Z score. In their merger simulation study, they also used simple method for merger but they considered all possible combinations and tested the significance unlike Boyd and Graham (1988) method. Some of the other problems of Boyd and Graham (1988), and Boyd *et al.*, (1993) as well as Brown *et al.*, (1996) are identified and have modified later on in section 5.5.2.

5.4. DATA COLLECTION

We gathered data from a number of different sources. In chapter two, we have created our data sample for life assurance, general insurance and insurance broking in European context. For Bank Holding Companies (BHC), data have been collected from FT EXTEL 1997. To collect banks' own insurance subsidiary data, we have had to go through a long arduous process.

We have initially taken The Banker's (1994) top 100 European banks out of top five hundred European banks. We then started a manual search from press clippings, industry reports, companies' annual reports, different directories etc. in order to ascertain how many out of top 100 have adopted bancassurance strategy. We have found that all the banks have at least some sorts of direct involvement in insurance business. We then started searching the banks involvement in life assurance underwriting, general insurance underwriting, and insurance broking. Here we faced some problems.

There are some banks who have 100% wholly owned insurance subsidiaries, while some have just 10% to 15% equity holding of underwriting insurance subsidiaries or even just a tied agreement/strategic alliance for joint sales. At this stage, we decided a criterion that we will take as our sample only the underwriting insurance subsidiaries that have over 50% equity holdings in the underwriting insurance subsidiaries. Fortunately 90% of the life assurance sample fall within this criteria.

We have decided to take only banks' own insurance underwriting subsidiaries (life and/or general insurance), excluding those who just have a tied agreement/strategic alliance for joint sales of insurance. This is because in a joint distribution agreement, banks bear very little risk¹, and underwriting insurance companies bear the main risks since if claims arise underwriting companies will have to bear the claims, not the banks. If banks can sell insurance they will get commission/fees from the underwriting companies otherwise not. Therefore, the main risk ultimately falls on the insurance underwriters.

We have also excluded strategic groups for insurance distribution, but we have included banks that have wholly owned insurance broking subsidiaries to see the impact of banks' involvement in insurance broking business.

One thing to note here is that there are some banks within the top 100 that do not have any insurance underwriting subsidiaries. These banks have a tied relationships or strategic alliance agreement with traditional big insurers for insurance distribution. For instance, Dresdner Bank, which is in the 12th position by assets size, has a strategic alliance with Allianz in Germany. On the other hand, we have found some banks in our manual search that are not in the top 100, but have insurance underwriting subsidiaries. For example, Leeds Permanent Building society in the UK has a life assurance underwriting subsidiary named Leeds Life. We have, therefore, included them in the sample and excluded the banks that have no underwriting or wholly owned insurance broking subsidiary in the top 100 list.

We have also found that some banks have more than one *life* insurance underwriting subsidiaries (TSB in the UK, Credit Lyonnais in France) in addition to general insurance underwriting subsidiaries and broking subsidiaries, while some have just one life underwriting or broking subsidiary. Anyway, we have included them all.

However, after a long time-consuming manual search, we have found 58 life assurance underwriting subsidiaries, 18 general insurance underwriting subsidiaries, and 22

¹ For details please see universal banking in the United States, what could we win, what could we lose?, Walters

insurance broking subsidiaries². This is reported in Appendix III. Most of the wholly owned insurance subsidiaries are domestic companies. Only two (Generali, and Bishopgate insurance) in our sample are cross-border mergers.

Now, the next stage is to collect the data of the above sample. At this stage, we also faced severe problem. Accounting data have been collected from the period of 1991-1996. Researchers always have to pay attention while collecting data, in particular, to the validity and the accuracy of data. Accounting data have been collected from the companies published annual reports and accounts. This is probably the most reliable method and is widely used in empirical analysis.

To get the accounting data, we first searched in the commercial sources like FT EXTEL, Data Stream etc. but we did not succeed. We then wrote to the individual European countries insurance regulators, specifying the names of the insurance companies. We had a very little success in this process. We then wrote to individual parent banks, specifying their insurance subsidiary name, to supply us these subsidiaries data and we got some effective response after a second reminder letter.

But still these samples are not sufficient to run a valid statistical test. We then wrote to the banks' insurance subsidiaries directly. Here also after a second reminder letter, we have got some positive reply. But still we fail to get some companies data. This is because probably they do not want to disclose their data to the outside world.

& Saunders, (1994), Cambridge university Press, New York, 1994.

In the final stage, we created a databank in spreadsheets from the annual accounts. Also this time, we face some potential problems. Our sample is an international base sample. Therefore, different countries will have obviously different accounting system and different timing period of accounts. Moreover, different countries have different currency, and local companies produce accounts in local currency. We, therefore, can not combine all the different company's data together. To solve this problem, we converted the local currency data to the European Currency Unit (now Euro) year by year.

All the insurance subsidiary data are 31st of December in each final year in all the countries in our sample. Only in the UK two banks have 31st of March timing period data. We believe this should not bias our results. Though different countries may have different accounting systems, our sample is within the EC countries³. The EC Directive has harmonised the accounting system within the member countries. Moreover, our variables are too broad [like total assets, total net income etc] to have a potential bias.

The UK life assurance companies, data have been collected from the DTI (now FSA) returns. We also face problem with the UK data. UK life assurance companies have to submit their returns in a specific prescribed form, supplied by the DTI. The DTI forms do not indicate shareholders equity, and net income. We, therefore, have taken minimum required margin (form 9) as a proxy of shareholders equity. If a life assurance company become insolvent, this required minimum would be used as shareholders equity. Net income is calculated as total income minus total expenditure including taxation⁴.

There may be an argument in selecting accounting data verses economic data. Each has advantages and disadvantages. But there is not a totally satisfactory explanation as yet

² Country profile and cross border proportion are reported in Appendices III.

³ We have included Switzerland in our sample. Though this country is not within the EC but it is treated as if it is a member of the EC in case of the financial services.

⁴ Brown *et al.*, (1996) adopted similar proxy in their study of UK life companies return and risk characteristics.

which data is most suitable for empirical analysis [e.g. Greenawalt and Sinkey (1988); Mehra and Prescott (1985); Franklin *et al.*, (1982)]. However, we did not have any choice in selecting data due to unavailability of economic data.

We have selected our banks sample if and only if a bank has at least any of the wholly owned insurance subsidiaries, i.e. either life assurance underwriting subsidiary or general insurance underwriting subsidiary or insurance broking subsidiary. 44 banks, 40 life assurance companies, 12 general insurance companies, and 11 insurance broking companies have been found by applying this criterion to our observations⁵. Sample firms for the bancassurance test are shown in Appendix IV.

5.5. METHODOLOGY

We use one measure of profitability and two measures of the risk of failure (bankruptcy risk) that take into account average rates of return, the variability of rates of return, and the level of capitalisation. First we analyse the risk/return characteristics of the various existing industries. (Table 5.2). Using our sample, we compute sample risk and return statistics for each industry. [This is done by calculating each company's mean return and risks over the sample period and then by aggregating them to each industry's mean return and risks characteristics]. This analysis provides an objective look at the historical relative risk and profitability in these industries. It also provides a basis for comparison with the second, i.e. mergers part of our study. There we analyse the effects of BHC expansion into insurance activities. This approach let us generate sample risk and return statistics for merged industries [like BHC-life assurance industry etc]. To see the effects

⁵ The sample size decreases because we dropped out some samples due to the lack of availability of data for the whole sample period.

of the mergers, these statistics are compared to risk and return statistics for the unmerged BHC industry.

5.5.1. Risk and Return Measures **Before** Merger

Let π_t be the net after tax income and A_t the book value of total assets in period t . The profitability of a company before and after the acquisition is the measure of the return on book assets which is measured by

$$R_t = \frac{\pi_t}{A_t} .$$

Profitability for the entire sample period is measured by the arithmetic mean

$$\bar{R} = \frac{1}{T} \sum_{t=1}^T R_t$$

The first risk measure, σ , is a measure of the volatility of rate of return on assets or, more precisely the standard deviation of R which is defined as

$$\sigma = \sqrt{\frac{1}{T-1} \sum_{t=1}^T (R_t - \bar{R})^2}$$

The second risk measure, 'Z' (or Z score, which is always negative) is an indicator of the probability of bankruptcy developed by Boyd and Graham (1988) and Boyd *et al.*, (1993).

One reason for using the risk measure Z is that, from a public policy perspective, the risk of failure of bank subsidiaries is the primary concern regarding BHC product line expansion.

The development of Boyd and Graham's (1988) 'Z' score is driven as follows:

$$Z = \frac{k_t - \bar{R}}{\sigma}$$

$$\text{where } k_t = -\frac{E_t}{A_t}$$

If we define bankruptcy as the situation in which equity E is insufficient to offset losses, or $\pi_t < -E_t$, then the probability of bankruptcy is given by

$$P(\pi_t < -E_t) = P\left(\frac{\pi_t}{A_t} < -\frac{E_t}{A_t}\right) = P(R_t < k_t) = P\left(\frac{R_t - \bar{R}}{\sigma} < \frac{k_t - \bar{R}}{\sigma}\right)$$

From Bienayme-Tchebycheff inequality we have that

$$P(R_t \leq k_t) = \left(\frac{\sigma}{\bar{R} - k_t} \right)^2 = \frac{1}{Z^2}$$

For further details, please see Boyd and Graham (1988), Boyd *et al.*, (1993) and Brown *et al.*, (1996).

5.5.2. *Risks and Return Measures After Merger*

Before assessing the impact of mergers, we compute for each bank's the mean ROA, standard deviation (σ), and Z score for the period of 1991 to 1996. We then compute the same statistics for each life assurance company, each general insurance company, and each insurance broking company over the same period. [It is important to note that we first compute individual firm statistics and *then* aggregate. Risk measures are never computed using industry average (or total) returns. Because that method would lower estimates of the industry risk measures by some unknown amount. We are interested in the riskiness of the average firm in the industry, not the riskiness of the industry average.]

Next, we compute the correlation coefficients between returns on banks and insurance companies. To do so, we compute the individual correlation of returns between each insurance company and each bank. This figure gives an indication of how the returns in insurance and banking have been correlated over time. If the mean correlation is relatively high, we can not use the simple combination method (*just adding banking and insurance raw data for merger*) like Boyd, Graham (1988), and Brown *et al.*, (1996) because such combinations ignore the correlation of returns between banks and insurance. In the Boyd and Graham (1988) merger simulations, firm pairs were chosen at random and the data entirely determined the relative portfolio weights of banking and non-banking assets. Portfolio weights thus were not varied, and they made no attempt to ascertain the optimal (risk-minimising) combination. Though Brown *et al.*, (1996) overcome random selection problem by allowing all possible combination, still some problem remains. They, like Boyd and Graham (1988), also used *adding method* in their merger simulation study. In

our case instead of using simulation merger, we use actual merger analysis (discussed in Chapter 2).

We include a bank in our sample analysis if and only if it has a wholly owned life assurance subsidiary and/or general insurance subsidiary and/or insurance broking subsidiary. Here for our analysis, we not only consider the impact of life assurance like Brown *et al.*, (1996) but also general insurance and insurance broking activities by banks and, instead of only one country perspective, we consider from the European perspective.

Instead of using simple adding combination method for merger analysis, we employ an alternative method to overcome the *adding* problem. We use portfolio approach. The portfolio approach is appealing because it allows an analysis of varying asset combinations and computation of the risk-minimising portfolio weights. Furthermore, we know that the risk effects of combining a bank with a firm from one of the other industries (different insurance industries in this case) depend not only on the standard deviation of returns in each industry, but also on the covariance between returns.

Following Markowitz (1952), the return and risk measures associated with a portfolio can be derived as follows:

The return of the combined entity (post-merger) is given by

$$R_{BA} = w_B R_B + (1 - w_B) R_I$$

where R_B , R_I , and R_{BA} , are the returns on the bank, insurance entity and the combined entity respectively and w_B is the proportion of banking assets in the combined entity.

The variance of the combined entity's return is given by

$$\sigma_{BA}^2 = w_B^2 \sigma_B^2 + (1 - w_B)^2 \sigma_I^2 + 2w_B(1 - w_B)\sigma_{BI}$$

where σ_B, σ_I , are the standard deviations of the bank, and insurance entity returns and σ_{BI} , is the covariance of returns. Boyd and Graham (1988) pointed out the firms effect and time-stationary problems in the merger analysis. We overcome the firms effect by employing each company's variance and the time-stationary problem by employing each year by each year combination.}

The Z-ratio is given by

$$Z_{BA} = \frac{k_{BA} - \bar{R}_{BA}}{\sigma_{BA}}$$

where $k_{BA} = w_B k_B + (1 - w_B)k_I$

5.6. ESTIMATION AND RESULTS

For the comparison of the two groups, either an independent t-test or a paired t-test is employed in the parametric approach. The independent t-test is employed when two unrelated groups of subjects are used, and the paired t-test is employed when the two related paired groups are used. We, therefore, employ the paired t-test for the actual merger of pair wise combination of return and risks characteristics between banks and their own different insurance industries.

The results of this test for the mean differences between banks and different insurance industries in terms of return and risks are shown in Table 5.2.

5.6.1. *Return and Risk Results Before Merger*

The *return* (Table 5.2.) in the industry (aggregation from firm to industry) estimation between the banks and the different insurance industries show that the insurance broking activities have the highest returns and life assurance underwriting activities have the lowest returns among all the activities. The general insurance underwriting activities and the insurance broking activities have significantly higher return than the banking activities (e.g. 5808 vs. 3.196 and .5808 vs. 49.51 respectively) and life assurance underwriting has lower return than banks but not significantly (-27.75 vs. .5808).

The *risks* in the industry (aggregation from firm to industry) estimation between the banks and the different insurance industries, i.e. life assurance underwriting, general insurance underwriting, and insurance broking, show that all the insurance activities have

higher risks than the banking activities (Table 5.2). General insurance underwriting and insurance broking have significantly higher risks than banking in terms of σ risk measurement, and the life assurance underwriting and the general insurance underwriting have significantly higher risk than banking in terms of Z-score risk measurement.

Table 5.2

Mean Value of Returns & Risks *before* merger
(Banks vs. Banks' Insurance industry)

European industry groups	Profitability		Risk Measurements			
	$\bar{R}$ (%)		σ		Z –score	
	Bank	Bancassurance	Bank	Bancassurance	Bank	Bancassurance
Banking activity vs. bank's life assurance underwriting	.5808	-27.75 (.754)	.4840	66.66 (1.254)	258.54	37.06 (1.829)*
Banking activity vs. bank's general insurance underwriting	.5808	3.196 (2.158)**	.4840	6.102 (4.948)***	258.54	14.87 (2.160)**
Banking activity vs. bank's insurance Broking	.5808	49.51 (6.091)***	.4840	32.66 (3.352)***	258.54	5.31 (1.115)

$\bar{R}$ = Mean of mean return; σ = Standard deviation; *t value in brackets()*; significant level ***=1%, **= 5%, and *=10%. Bancassurance = Insurance companies owned by banks.

5.6.2. Return and Risk Results *After* Merger

The industry results, reported above, of course have some interest. Because from this industry analysis we can find which industry is less risky and more profitable or *vice versa*. But the industry analysis provides little information on the risk effects of *combining* banks with firms from other insurance industries. As we mentioned earlier that the risk

effect depends not only on the distributions of banks and non-banking profits, but also on the correlation among them. Therefore, we calculated correlation.

Table: 5.3

Correlation of return from banking and insurance activities in an combined entity	
Life	0.0094
General	0.3147
Brokers	-0.0184

From the Table 5.3, it is seen that Bank Holding Companies and General Insurance companies return have a higher correlation while the Bank Holding Companies and Insurance Broking have negative correlation. This suggest that the banks combination with insurance broking would be better off and the opposite effect with the combination with general insurance. The life assurance is in the middle position among the three insurance activities.

Nevertheless, the diversification effects is tested by testing whether the return and risk of the combined entity are statistically different from the return and risk of the banks alone that have acquired the insurance enterprises. We use paired t-test for a pair wise combination between the banks and the banks and different insurance groups combined. The results of this test for a mean difference between the banks and the banks and insurance companies' combined in terms of return and risks are shown in Table 5.4.

Table 5.4

Mean Value of Returns and Risks *after* Merger (Bank vs. Bank & insurance combined)

European industry groups	Profitability		Risk Measurements			
	$\bar{R}$ (%)		σ		Z Score	
	Bank	BAIC	Bank	BAIC	Bank	BAIC
Bank alone vs. bank & life assurance combined	.5146 (2.335)**	.8365	.2585 (1.444)	.4405	249.64 (2.029)**	56.91
Bank alone vs. bank & general insurance combined	.4291 (1.480)	1.892	.1218 (2.361)**	1.630	163.99 (1.751)*	24.69
Bank alone vs. bank & insurance broking combined	1.186 (2.015)*	1.595	1.163 (.877)	.7440	354.24 (1.011)	64.20

$\bar{R}$ = Mean of mean return; σ = Standard Deviation; BAIC = Bank And Insurance Combined; *t* value in brackets(); Significant level ***=1%, **= 5%, and *=10%.

The *returns* on the actual merger results (Table 5.4) show that between banks merger with *life assurance underwriting companies* and the banks merger with *insurance broking companies* significantly increase banks' return (.5146 vs. .8365, and 1.186 vs. 1.595 respectively) and although return in *general insurance underwriting* increases but not significantly (.4291 vs. 1.892).

The *risks*, in the merger analysis (Table 5.4), show that *the bank merger with general insurance underwriting companies* significantly increase banks risk in terms of σ risk measurement (.1218 vs. 1.630) as well as Z-score risk measurement (163.99 vs. 24.69).

The banks merger with life assurance underwriting companies also significantly increase banks risk in terms of Z-score risk measurement (249.64 vs. 56.91) and although risks increase in other risk measurement, but not significantly. However, in *the banks merger with insurance broking* although the risks increase slightly but not significant in any risk measurements. Therefore, on the basis of above return and risks criteria, this analysis suggest that insurance broking is most suitable for banks among all the three insurance

activities, because in insurance broking the return increases significantly and the risk does not have any significantly effect. We can further summarise the results in the Table 5.5.

Table 5.5.

The post-merger significance results of returns and risks
within the Bancassurance Groups

Bancassurance Groups	Profitability	Risk
Bank merger with Life Assurance Underwriting	✓	✓
Bank merger with General Insurance underwriting	×	✓
Bank merger with Insurance Broking	✓	×

Note: Based on only the significant results. ✓ = significantly increase; × = no significance.

From the Table 5.5, it is clear that the return and the risks increase simultaneously in the bank merger with the life assurance underwriting activities. According to risk/return theory, this is a normal situation, i.e. higher return in higher risks. The post-merger increasing profitability in life underwriting may be the cause of the relatedness of business activities between banking and life assurance. Rumelt (1974) argued that related diversification affects value more positively than unrelatedness. Therefore, the banking activities and the life assurance activities may have relatedness to each others.(i.e. mortgage and life assurance). There may also be the existence of scope economies [e.g. Dickinson & Dinenis (1992); OECD (1992); Dinenis & Jung (1999)] of bancassurance companies. Banks have countrywide branch network with huge number of bank staffs for the vast client base. Since distribution costs represent a higher proportion of total costs of life products. [e.g. Llewellyn (1994)], banks by introducing insurance distribution through the branch network channel can increase profitability. But the underwriting activities are conducted in separate workshop and by separate life underwriting specialists, i.e.

actuaries that gives little chance for scope economies. Moreover, the long-term nature of life assurance contracts itself as well as the inappropriate/complex management structure may cause increasing risk.

However, the banks' merger with general insurance underwriting companies' do not provide any significant profit, instead it significantly increase bankruptcy risk of banks (Table 5.5). This is quite interesting, i.e. no significant post-merger returns but the significant increase of risk. Underwriting general insurance requires knowledge of specialised risks [e.g. Kane (1994)], therefore, most of them are not closely related to traditional banking activities.[e.g. Rumelt (1974); Kane (1994); Saunders and Walter (1994)]. Banks general insurance underwriting companies underwrite very few general products (motor, household etc.) in a limited way (Discussed in Chapter two). This also may downturn returns and upraises risks of banks in the general insurance underwriting activities. Furthermore, the nature of the general insurance underwriting activities itself is risky, i.e. unexpected loss like heavy storm, flood, or other natural dissenters.[e.g. Saunders & Walter (1994)]. This argument is also supported by our industry analysis (Table 5.2), i.e. general insurance underwriting is significantly riskier than banking industry and diversifying into this risky area should increase risk.

On the other hand, the bank merger with insurance broking companies significantly increase banks profitability and no significant risk effect (Table 5.5). Brokerage is mainly a commission/fees oriented business and the sales and services dimensions are closely aligned with some of the other services conducted in banking. Furthermore, broking is not

a capital utilising activity, and hence there is little risk to which an institution's capital is exposed through brokerage. [e.g. Kane (1994); Saunders & Walter (1994)].

Llewellyn (1994) mentioned that if the probability of failure is reduced diversification should be allowed, and if the seriousness of failure is increased diversification should be limited. Based on our results we recommend that banks should not either engage in life assurance underwriting or in general insurance underwriting business if they are concerned about risk effects. But the insurance broking should be permitted.

The main objectives of the regulators are to minimise risks for the protection of the depositors and policyholders. [e.g. OECD (1992); Carter & Dickinson (1992); Bank of England (1993); Fever (1993); Berghe (1996)]. Therefore, the regulators in Europe should tighten the regulatory barriers for banks' entering into life as well as general insurance underwriting business in order to minimise the banks' bankruptcy. However, the banks should be permitted in engaging insurance broking activities.

5.7. CONCLUSION

According to the portfolio theory diversification spreads the risks and thus reduces risk. In our analysis in this chapter, the thesis investigated European banks' diversification into different insurance business, namely, life assurance underwriting, general insurance underwriting, and insurance broking business. Over the six years period of investigation from 1991 to 1996 on European banks and their own life assurance underwriting subsidiaries, general insurance subsidiaries, and insurance broking subsidiaries, we found some interesting results. In our estimation (pre-merger analysis), it is seen that life assurance and general insurance underwriting activities appear to be more risky than

banking. The return between life assurance underwriting and banking as well as the return between banking and general insurance underwriting do not have significant effect. However, insurance broking has significantly more positive return than banking and the risks between them do not have significant effect.

In the post-merger analysis, we find that the merger with life as well as general insurance underwriting significantly increases banks' risks. However, the merger with insurance broking companies significantly increases the banks return and the risks do not have significant effect. Therefore, since the regulators objectives is to minimise the risk of bank/insurance company's failure, our results suggest that European banks should not be permitted to acquire life and general underwriting companies. But they may be permitted to acquire insurance broking companies on the grounds that though the risk increases in engaging insurance broking, this does not have a significant effect, instead the returns significantly increase when banks engage into insurance broking.

One may argue that allowing banks in engaging different insurance operation may be cost effective, i.e. possibility of scale and scope economies in combining banking and insurance business. But several studies have found little evidence of scope economies in combinations of banking and non-banking firms [e.g. Rhoades and Boczar (1977); Dinenis & Jung (1998)]. Some studies have even found evidence of diseconomies of scale [e.g. Humphrey (1990)]. Anyway, this is a separate issue and needs to be tested separately from the European bancassurance perspective.

CHAPTER SIX

TESTING RETURN AND RISK EFFECTS OF INSURANCE COMPANIES DIVERSIFICATION INTO BANKING BUSINESS

6.1. INTRODUCTION

The purpose of this Chapter is to investigate the impact of acquiring banks by the European insurance companies on the return and risk effects. This is opposite to Chapter five. To the best of our knowledge this is the first attempt to quantify the benefits of assurancebank. Engaging into another risky business like banking may increase insurance companies' bankruptcy risk. On the other hand, due to a diversification, the insurance companies may spread the risk and thus reduce their bankruptcy risk. As the insurance companies have adopted this strategy very recently, there is a lack of available data. Due to the lack of availability of data we conduct a merger simulation study in order to assess the impact.

The rest of this chapter is as follows: in section 2, we discuss the review of literature; section 3 describes the methodology and data collection; section 4 is the simulation results; and section 5 concludes.

6.2. REVIEW OF LITERATURE

Banks in Europe are permitted by the regulators to engage into insurance business. [OECD (1992); CEA (1992)]. They are permitted not only for the insurance distribution but also for the core insurance activities, i.e. underwriting of insurance. This is a serious threat to insurance companies. Earlier (during 80s) when European banks started distribution of insurance, insurance companies used to underwrite the insurance products and banks used to distribute these insurance products through bank's branch net work in addition to insurance companies' traditional channels. In this way, they had a principal-agent relationship, insurance companies as principal and the banks as agent. Such insurance companies - banks' agency relationship was a threat for traditional insurance intermediaries as these banks used to compete directly with the traditional insurance intermediaries in intermediaries market. Insurance companies by employing banks as insurance intermediaries used to get an extra strong channel for distribution of insurance. In other words, insurance companies used to get huge volume of business from a single source, i.e. banks channel. Soon after words when banks realised that insurance business was a good prospect for them, and as they had now learnt the 'know how' of distribution of insurance¹, they started withdrawing support of distribution from traditional insurance companies². Instead, they established their own underwriting insurance ventures and distributed their own underwriting products. (reported in Chapter two). Therefore, the insurance companies have not only lost their strong distribution channel but also directly faced competition from the banks. This time not the intermediaries but the underwriters face a serious threat from banks. If only the banks are permitted to engage into insurance business but not the insurance companies

¹ Because European banks have been distributing insurance for a number of years.

² For instance, UK's Halifax, Abbey National, Nationwide etc.

in banking, then this will produce an imbalance between the banking and insurance industries as banks will share the insurance market share with insurance companies and not the banking industry's market share by insurance industry. Therefore, insurance companies should have similar opportunity to compete with banks as part of a fair deal. For this, the insurance companies may adopt a defensive strategy, which can be termed as the 'Assurancebank' strategy. As a defensive strategy insurance companies then can diversify into banking business in addition to their traditional insurance business and can offer one stop financial shopping

But the fundamental questions are, should insurance companies be permitted to diversify into banking business in the context of liquidation of risk or bankruptcy risk as insurance business is regarded as a risky business? Or should they be prohibited from engaging in banking business by the regulators as banking business is regarded as risky business too? The regulators are deeply concerned about the possible liquidation or bankruptcy risk for the sake of public interest. If a company goes bust, huge numbers of investors will lose their savings and the public will lose faith in financial institutions. If this were to happen, there would be serious consequences for the stability of the country's economy. Therefore, this is a crucial issue to be tested. Whereas emphasis has been placed to look for the phenomenon of 'Bancassurance' [e.g. Diacon (1990); Dickinson & Dinenis (1992); Hoschka (1994); Brown et al., (1996)], less attention has been paid to 'Assurancebank', i.e. acquisition of banks by insurance companies.

Diversified firms by definition are collection of businesses. These individual businesses compete in different industries. The different industries have different structural characteristics and these different structural characteristics result in different average (and potential) profits in each industry. This is in fact a central tenet of microeconomic theory and industrial organisation economics [e.g. Bettis & Hall

(1982); Scherer (1980); Shepherd (1979)]. Chandler (1962) established the general nature of diversified firm and the interaction of organisational structure with diversification. This was later refined by Wrigley (1970), Rumelt (1974), and by others. Two distinct modes of diversification have been identified: unrelated and related. Unrelated diversifiers have been defined as firms that diversify predominantly across industries, while related diversifiers have been defined as firms that diversify predominantly within industries [e.g. Palepu (1985); Kim, Hwang & Burgers (1989)]. Of course insurance companies' diversification into banking falls in the unrelated group. Unrelated firms do not enjoy superior risk-pooling characteristics and that the superior returns attributed by Rumelt (1974, 1977) to related diversification may be due largely to industry effects [e.g. Bettis & Hall (1982)]. The arguments linking diversification to profit stability revolve around the portfolio notion, which suggests that investing in diversified stock with non-correlated profits can reduce the volatility of a firm's total profits [e.g. Markowitz (1959); Tobin (1950)].

But a diversification strategy with a favourable return may not be managerially acceptable due to its risk [e.g. Kim, Hwang & Burgers (1989)]. Therefore, the risk is an important factor to be considered with strategy. However, the leading hypothesis is that diversification increases markets power and should, therefore, result in greater profitability for diversifier [e.g. Caves (1981); Miller (1973)]. Empirical results of industrial organisational studies, however, have not found a positive relationship between the extent of diversification and profitability [e.g. Gort (1962); Arnould (1969); Markham (1973)].

The importance of incorporating risk into diversification studies has been asserted by a number of strategy researchers [e.g. Chang & Thomas (1989); Bettis & Hall (1982); Baird & Thomas (1985)]. Since Chang & Thomas (1989) argued that diversification is

a well-defined strategy and its impact on risk and return can be empirically examined. Our study, therefore, may add further insight into the relationship between strategy and risk and return.

In case of financial firms like insurance, it may be said that insurance companies have higher risk than banks because of the catastrophes of risk and nature of their business. If the insurance companies were allowed to engage in banking business, the risk (measured by the volatility of insurance companies' profitability) would decrease because of the effect of asset diversification. On the other hand, such risk might increase, but that increase would be more than compensated for by an increase in average profitability. Therefore, the insurance companies' failure would decrease. There may be another argument as to whether or not risk would increase, as it is not a problem because insurance companies' banking subsidiaries will be legally protected. But if the banks exist as stand alone basis, its maximum risk will not be more than zero (0). In case of a subsidiary of an insurance company, the maximum risk will be -1, because as a parent company it would have to compensate for the extra negative value of that banking subsidiary.

We have found some real data of insurance groups' banking income, which is reported in Table 6.1. In Table 6.1, we have shown the contribution from banking income to net income of insurance companies. From this table, we see that eight out of ten companies have positive banking income, only two companies have negative banking return. It seems expanding into the banking arena is likely to be profitable one. However, we can not conclude on the basis of this. We, therefore, employ a simulation analysis to test the impact of Assurancebank. Boyd and Graham (1988) developed a model to test return and risk effects of bank diversification into insurance business, a simulation study based on the US data.

Table: 6.1

Assurancebank's contribution in insurance groups profitability, 1996

Insurance groups	Total assets (£m)	Net income (£m)	Banking income (£m)
Aegon NV	57439	492	328
AGF Assurances Generales de France, STE CEN	43638	162	9
Cardif SA	9261	36	4
Codan Forsikring	5217	99	11
FINAXA	118456	119	1959
GAN, STE Centrale Dhaka University	86208	-188	-93
ING Group NV	151778	1042	669
Trygg Hansa AB	2692	194	-3
UAP, CIE	91957	-217	10

Source: Derived from FT EXTEL 1997

In the US and the rest of the world, this cross section activity is prohibited³. But in Europe, this is allowed in both the cases, i.e. banks into insurance as well as insurance companies into banking diversification.

Eisemann (1976) conducted a study by using market data to derive an efficient multiple activity frontiers, over the period of 1961-1968. He found that Bank Holding Companies (BHCs) would have significantly increased their risk if they had expanded in permissible and non-allowable non-bank activities. Litan (1987) constructed pair wise portfolio selection approach with pair-wise combination of banking and non-banking activities. He used the accounting data *ROA* (Return on Asset) to capture the rates of return and *CV* (Coefficient of Variation) of returns as a risk indicator. A lower *CV* suggests that the activities might potentially be risk reducing. Over the period of

1962-1982, the study suggest that for seven out of nine activities considered, the risk adjusted return would have been equal or lower than banking alone. Boyd and Graham (1988) simulated mergers of randomly selected BHCs and non-bank financial firms like insurance, real estate etc. They used one measure of profitability, *ROE* (Return on Equity), and two measures of risk, i.e. standard deviation (σ) of *ROE* and 'Z' score developed by them. The higher the Z scores the lower the risk. The results, using US accounting data, indicated that only the mergers of BHCs with life insurance companies reduced bank risk. Further test by Boyd, Graham and Hewitt (1993) shows that engaging in life and property/casualty insurance activities yielded significant risk-reducing effects. Here, instead of using just adding method (combination of insurance and banking raw data in merger study), they scaled non banking firm data in each random merger in order to produce a predetermined initial portfolio weight, i.e. ratio of non banks most merger assets to total assets. Walter & Saunders (1994) conducted analysis of US banks diversification into different non-bank activities including insurance. They found that highest return per unit of risk would be obtained in the combination of banking with property/casualty insurance. Brown, Genetay, and Molyneux (1996) further developed the Boyd and Graham model. They include UK accounting data to conduct a simulation study of banks and building societies diversification into life assurance. In their simulation, they found that building societies and mutual life insurers would be significantly risk reducing. But for other combinations like building societies with proprietary life, commercial banks with proprietary life, and mutual life, risk would not significantly change measured by

³ only where there is not more than five thousand population. The Glass Legal Act 1933 separate insurance business from banking. There is a intense pressure in the US to liberalise the financial companies cross business activities.

standard deviation and covariance. However, risk would significantly fall, measured by Boyd Graham's Z score.

6.3. DATA

Accounting data were obtained from FT EXTEL 1997 for the period of 1991-1996. We only included companies with six years data of assets, equity and net income. We found 57 insurance companies and 40 large banks. The 57 insurance companies count for over 60% of the total European insurance companies' assets.

We divided the insurance sample into two groups, the first group from Euro 20 billion assets onward, and the other group from just below Euro 20 billion up to Euro 5 billion. We have found 38 companies that have over Euro 20 billion assets each and 20 companies that have lower than Euro 20 billion assets each. We call the upper bound as large insurance and the lower bound as medium insurance. Sample firms are shown in Appendix V.

To standardise the data sample, currencies are converted into European Currency Unit (now Euro) dated in 24/9/97 through the FT EXTEL. There may be questions about the potential biases with regard to combining different European countries' data. But FT EXTEL has set up the data so smoothly that we find no difficulties in selecting our sample. In Europe, all the countries keep their accounts in a same manner according to the EC Directives. Moreover, our variables are so broad [e.g. total assets, total net income] that biases should be eliminated.

6.4. METHODOLOGY

Following Boyd and Graham (1988) and Boyd, Graham & Hewitt (1993) and further Margaret Brown et al., (1996) we use the merger simulation framework to explore the

risk consequences of insurance companies diversification into banking business in Europe.

6.4.1. Risks and Return Measures **Before** Merger

Let π_t be the net after tax income and A_t the book value of total assets in period t . The profitability of a company before and after the acquisition is the measure of the return on book assets which is measured by

$$R_t = \frac{\pi_t}{A_t} .$$

Profitability for the entire sample period is measured by the arithmetic mean

$$\bar{R} = \frac{1}{T} \sum_{t=1}^T R_t$$

The first risk measure, σ , is a measure of the volatility of rate of return on assets or, more precisely the standard deviation of R which is defined as

$$\sigma = \sqrt{\frac{1}{T-1} \sum_{t=1}^T (R_t - \bar{R})^2}$$

The lower the standard deviation the lower the risk. We use this measure because this is very popular in banking, insurance and other business literature. Another reason is that this risk measure tests the insurance companies' banking expansion proponents. In other words, we can say that the insurance companies by engaging into banking business would reduce the volatility of rates of return because of asset diversification.

The second risk measure, 'Z' (or Z score, which is always negative) is an indicator of the probability of bankruptcy developed by Boyd and Graham (1988) and Boyd et al., (1993). Bankruptcy is defined as the situation where losses exceed equity. One reason for using the risk measure Z is that, from a public policy perspective, the risk of failure of bank subsidiaries is the primary concern regarding BHC product line expansion.

$$Z = \frac{k_t - \bar{R}}{\sigma}$$

$$\text{where } k_t = -\frac{E_t}{A_t}$$

The higher the Z score, the lower the risk of failure, and *vice-versa*.

The development of Boyd and Graham's (1988) 'Z' score is driven as follows:

If we define bankruptcy as the situation in which equity E is insufficient to offset losses, or $\pi_t < -E_t$, then the probability of bankruptcy is given by

$$P(\pi_t < -E_t) = P\left(\frac{\pi_t}{A_t} < -\frac{E_t}{A_t}\right) = P(R_t < k_t) = P\left(\frac{R_t - \bar{R}}{\sigma} < \frac{k_t - \bar{R}}{\sigma}\right)$$

From Bienayme-Tchebycheff's inequality we have that

$$P(R_t \leq k_t) = \left(\frac{\sigma}{\bar{R} - k_t} \right)^2 = \frac{1}{Z^2}$$

For further details, please see Boyd and Graham (1988), Boyd et al., (1993) and Brown et al., (1996).

6.4.2. Risk and Return Measures *After* Merger

Before conducting simulations, we compute each large and each medium insurance companies mean *ROA*, standard deviation (σ), and *Z* score for the period of 1991 to 1996. Then, in the same process, we compute each medium and each small banking companies mean *ROA*, standard deviation (σ), and *Z* score over the same period. [It is important to note that we first compute individual firm statistics and *then* aggregate. Risk measures are never computed using industry average (or total) returns because that method would lower estimates of the industry risk measures by some unknown amount. We are interested in the riskiness of the average firm in the industry, not the riskiness of the industry average as we did in Chapter five.].

We then compute the mean correlation of returns between unmerged and merged firms. To do so, we compute the individual correlation of returns between each insurance company and each bank. This figure gives an indication of combination about how the returns in insurance and banking would have correlated over time. If the correlation is higher we can not use the *simple combination* method, i.e. just *adding* banking and insurance raw data as merger like Boyd and Graham (1988) and Brown et al., (1996) because such combinations would have ignored the effect of correlation of returns between banks and insurance. Therefore, we have to find an alternative method. Instead of using *simple adding* combination method for merger analysis, we employ an alternative method to overcome the adding problem.

We use portfolio approach as we did in Chapter five. The portfolio approach is appealing because it allows an analysis of varying asset combinations and

computation of the risk minimising portfolio weights. Further more, the risk effects of combining a firm with a firm from other industry depends not only on the standard deviation of returns in each industry, but also on the covariance between returns.

Following Markowitz (1952), the return and risk measures associated with a portfolio can be derived as follows:

The return of the combined entity (post-merger) is given by

$$R_{AB} = w_I R_I + (1 - w_I) R_B$$

where R_I , R_B , and R_{AB} , are the returns on the insurance, bank entity and the combined entity respectively and w_I is the proportion of insurance assets in the combined entity.

The variance of the combined entity's return is given by

$$\sigma_{AB}^2 = w_I^2 \sigma_I^2 + (1 - w_I)^2 \sigma_B^2 + 2w_I (1 - w_I) \sigma_{IB}$$

where σ_I , σ_B , are the standard deviations of the bank, and insurance entity returns and σ_{IB} , is the covariance of returns. Boyd and Graham (1988) pointed out the firms effect and time-stationary problems in the merger analysis. We overcome the firms

effect by employing each company's variance and the time-stationary problem by employing each year by each year combination.

The Z-ratio is given by

$$Z_{AB} = \frac{k_{AB} - \bar{R}_{AB}}{\sigma_{AB}}$$

where $k_{AB} = w_I k_I + (1 - w_I) k_B$

Boyd and Graham (1988) considered random combination, and Boyd, Graham & Hewitt (1993) considered average portfolio approach in their simulation merger analysis. To see the impact of insurance companies' merger in our simulation merger analysis, we consider *all possible combinations* to avoid random bias and we calculate *actual* weight in the merger to avoid average weight bias.

6.5. SIMULATION RESULTS

In comparison of two groups, either the independent t-test or the paired t-test is employed in the parametric approach. The independent t-test is employed when two unrelated groups of subjects are used, and the paired t-test is employed when the two related paired groups are used. We, therefore, employ the independent t-test for the hypothetical merger between insurance and banking industries for their return and risks impact. Before conducting the test, we aggregate both insurance and banking firms to industries. This aggregation is conducted from the each and every company's computation of mean return, standard deviation (σ), and Z-score over the period of

1991-1996. The industry results of the t-test for the mean differences of return and risks between insurance and banking industries are shown in Table 6.2.

Table: 6.2

Mean Returns & Risks *before* Merger (Insurance vs. Banking) 1991-1996

Groups	Sample	Profitability		Risks			
		$\bar{R}$ (%)		σ %		Z-SCORE	
		Insur	Bank	Insur	Bank	Insur	Bank
Large Insurance vs. Bank	(37-40)	.6446 (2.879)**	.3407	.4693 (2.815)**	.2056	45.93 (2.171)*	78.73
Medium Insurance vs. Bank	(20-40)	.6459 (2.36)*	.3407	.5831 (3.109)**	.2056	82.62 (.106)	78.73
Large & Medium Insurance vs. Bank	(57-40)	.6451 (2.841)**	.3407	.5092 (3.206)**	.2056	58.45 (1.112)	78.73

Insur = Insurance companies; $\bar{R}$ = Mean of mean returns; σ = standard deviation.
Significant level: ***=1%, **=5%, *=10%. *t* value in brackets.

The above test shows that there are significant differences of *returns* between banking and insurance industries. The insurance industry has higher returns than banks. This is in all the groups' comparison, (i.e. .6446 vs. 3407; .6459 vs. 3407; and .6451 vs. 3407). Similarly, there are some significant differences of *risks* between insurance companies and banks. The insurance industry has higher risks than banks. This is also in all the groups' comparison and in both the risk measurements. For details please see Table 6.2.

The industry results, reported above, of course have some interest because from this industry analysis, we can find which industry is less risky and more profitable or *vice versa*. But the industry analysis provides little information on the risk effects of *combining* banks with firms from other (insurance) industries. We, therefore, simulate hypothetical mergers using annual accounting data over the period of 1991-1996. Each insurance company is coupled with each bank in the same year. In this way, we have

got $(37 \times 40 \times 6)$ 8880 merger cases for large insurance with banks, $(37 \times 20 \times 6)$ 4440 merger cases for medium insurance with banks, and $[(37 + 20) = 57 \times 40 \times 6]$ 13680 merger cases for large & medium insurance combined with banks. However, the actual merger cases are 1480, 800 and 2280 respectively due to six year average of each firms.

For the large & medium insurance companies’ combined merger with banks (LMIB), which have 2280 merger cases, we find 825 mergers appear to be profitable, that is around the 40% of the sample case. For the same group’s merger, we find 1482 merger cases decrease risk in standard deviation (σ) risk measurement, and 1439 merger cases decrease risk in Z-score risk measurement which is around 65% in both risk measurements. This indicates risk reduction in diversifying into banking business activities by insurance companies.

The large insurance companies’ mergers with banks (LIB) as well as for the medium insurance companies' merger with banks (MIB) have also similar results. (For details please see Table 6.3). Therefore, size of insurance group does not effect in merger with banks.

Table: 6.3

Post-Merger Benefits on Return and Risks						
Groups	LIB		MIB		LMIB	
	Merger Benefits		Merger Benefits		Merger Benefits	
Total Number of Hypothetical Merger	1480	100%	800	100%	2280	100%
RETURN	574	38.78%	251	31.37%	825	36.18%
STD (σ)	960	64.86%	522	65.25%	1482	65.00%
Z-SCORE	952	64.32%	487	60.87%	1439	63.11%

LIB = Large Insurance with Bank; MIB = Medium Insurance with Bank;
 LMI = Large & Medium Insurance with Bank.

As we mentioned earlier that the risk effect depends not only on the distributions of banks and non-banking profits, but also on the correlation among returns. Therefore, we

calculated correlation. Our calculation of the mean correlation coefficient on the return between insurance and banking groups are as follows:

Table: 6.4

Mean correlation coefficient on the return
between insurance and banking groups

Large insurance and bank	.7045
Medium insurance and bank	.7880
Large & medium insurance and small bank	.7338

The correlation in all the combinations is higher.

Now, like the pre-merger test (Table 6.2), we also use independent *t*-test in post merger analysis to compare the mean values between insurance companies with their newly hypothetical merged firms’ (i.e. assurancebank) return and risks. The simulation results of the t-tests are shown in Table 6. 5.

Table: 6.5

Mean Value of Return and Risks *after* Mergers
(Insurance vs. Assurancebank) 1991-1996

	Combination sample	Profitability		Risks			
		$\bar{R}$ (%)		σ %		Z-SCORE	
		IC	IABC	IC	IABC	IC	IABC
Groups							
Large Insurance with Bank Merger	1480	.6446 (4.54)***	.4220	.4693 (6.784)***	.2176	52.53 (2.674)	78.04
Medium Insurance with Bank Merger	800	.6459 (4.414)***	.3558	.5831 (5.845)***	.2031	82.62 (.039)	83.99
Large & Medium Insurance with Bank Merger	2280	.6451 (6.233)***	.3988	.5092 (8.940)***	.2125	58.45 (1.179)	74.33

IC = Insurance Companies; IABC = Insurance And Banking Combined; $\bar{R}$ = Mean of mean returns; σ = standard deviation;. Significant level: ***=1%, **=5%, *=10%. *t* value in brackets.

The results in the Table 6.5 show that there are significant differences of returns between insurance companies and assurancebanks. Insurance companies have higher returns than assurancebank companies. This is in all the three groups combination, (i.e. .6446 vs. .4220; .6459 vs. 3558, and .6451 vs. 3988).

However, insurance companies significantly decrease their risks when diversifying into banking business. The standard deviation (σ) decreases significantly in all the groups, (i.e. .4693 vs. .2176, .5831 vs. .2031, and .5092 vs. .2125). Risks also decrease in other risk measurement i.e. Z score. For details please see Table 6.5.

From the above analysis, we see that from a firm's profit point of view the assurancebank strategy does not appear to be suitable. But from a firm's risks point of view this strategy appears to be suitable one since standard deviation (σ) significantly decreases. This reduction means that the return would be consistent. Holsboer (1993) pointed out that the European insurance companies have adopted assurancebank strategy for both *defensive* and *the offensive* reasons. The offensive strategy appears to be less successful since assurancebank firms can not increase profitability. On the other hand, viewed from the defensive strategy, it appears to be more successful in the sense that adopting assurancebank strategy by the European insurance companies reduces standard deviation (σ) to secure their consistent returns.

Moreover, customers those who prefer so called 'one stop financial shopping' can be retained by the insurance companies, otherwise losing these existing customers would have been further threat for insurance companies for survival. Swiss Re (1992) market

survey shows that a significant number of customers (around 34%) prefer 'one stop financial shopping'.

The major commercial banks in Europe have moved into insurance business. Others are planning to follow the same route. Insurance market share is increasing day by day the Bancassurance companies. Above all, most of the big banks have already entered into core insurance business, i.e. underwriting of insurance. Customers are moving towards banks insurance services due to one stop financial shopping [Swiss Re (1992)]. All these are a serious threat for insurance groups. Bearing in mind of such heavy threat from Bancassurance companies, the above analysis suggest that the strategy of Assurancebank by the European insurance groups may be desirable as a counter response, and for a balanced competition with Bancassurance companies to retain market position.

Further more, assurancebank might be more successful in terms of scale and scope economies since there is an opportunity of cost reduction for jointness of banking and insurance products, particularly in marketing. In this thesis, we do not examine economies of scope or scale that may result from such merger. The theoretical arguments have been presented elsewhere [see Dinenis and Jung (1998); Hoschka (1994); Dickinson and Dineñis (1992); Grant (1992)].

From the regulatory authority point of view, the assurancebank appears to be suitable since their bankruptcy risks decreases (according to Z-score risk measurement in Table 6.5). The regulators prime concern is minimising risks by applying different regulatory tools to *safe guard the economy* and to *protect the depositors and the policyholders*

[Berghe (1996); Brady (1995); Kane (1995); Carter and Dickinson (1992); OECD (1992)].

6.6. CONCLUSION

Over the period of the six years observation from 1991 to 1996 in Europe, the results of merger simulation supports risk reduction but does not improve the insurance companies' return significantly.

The regulators in Europe have permitted banks to diversify into insurance business. Most of the big banks have already entered into core insurance business, i.e. underwriting of insurance. Customers are moving towards banks insurance services due to one stop financial shopping [Swiss Re (1992)]. All these are a serious threat for insurance groups. Bearing in mind of such heavy threat from bancassurance companies, the adoption of *assurancebank* strategy by the European insurance groups may be suitable as a counter response, and for a balanced competition with bancassurance companies to retain market position.

The above results are based on simulation analysis, which is academic, and in actual merger analysis, the diversification may increase insurance companies' profitability. Furthermore, one may argue that *assurancebank* might be more successful in terms of scale and scope economies since there is an opportunity of cost reduction for jointness of banking and insurance products, particularly in marketing. In this thesis, we do not examine economies of scope or scale that may result from such merger. On the other hand, there may be diseconomies of scope, because running a bank branch will be more

costly than running an insurance agency. Furthermore, since the underwriting activities will be conducted separately by separate personnel, there will be little chance of having the scale and scope economies. Anyway, this is a separate issue and needs to be tested separately from the European *assurancebanks'* perspective.

CHAPTER SEVEN

SUMMARY FINDINGS, POLICY RECOMMENDATION AND SUGGESTIONS FOR FURTHER RESEARCH

7.1. INTRODUCTION

The purpose of undertaking this research was to examine the interface of insurance and banking and its effects from the European context. We considered a number of relevant issues and their impact. The purpose of this chapter is to summarise the findings of this research, and make some policy recommendations based on the findings. We mentioned earlier that this research had two parts. In the first part (Chapter two, three and four), we investigated the various interfaces both from the perspective of a bank as well as from the perspective of an insurance company. In the second part (Chapter five and six), we performed empirical tests of the effects, i.e. of bank involvement into insurance business, and insurance companies involvement into banking business.

The rest of the chapter is organised in the following way: - in section 2, we summarise the findings; in section 3, we make some policy recommendations based on our findings; in section 4, we identify some of the limitations of this thesis, and suggest some of the issues for further research.

7.2. SUMMARY FINDINGS

The most important of our findings is that of return and risk effects of banks as well as insurance companies cross-business activities. Another major contribution, in this thesis, is the creation of a databank from the European context and from the bancassurance perspective as well as assurancebank perspective. These data can be invaluable for further research and development on this crucial issue.

Our two sets of empirical tests, based on return and risks, show that banks significantly increase their risks when they diversify into life assurance underwriting and general insurance underwriting business. On the other hand, although insurance companies bankruptcy risk increases slightly, other risk measurement (σ) indicates significant risk reduction when they diversify into banking business. Returns in both cases do not have significant effect. Only insurance broking by banks has significant positive return, and acquiring medium banks by large insurance have significant negative return. Engaging into insurance broking by banks slightly increases banks risk but does not have any significant effect (Chapter five).

The main questions, we ask in this thesis, are- should banks be allowed in insurance business? If so, in what capacity - distribution only or underwriting as well? In what sector - life assurance or general insurance as well? Again, should insurance companies be allowed in banking business?

Our results do not favour underwriting activities (Chapter five and six). Insurance broking appears to be most suitable out of all the three insurance activities. On the other hand, (at least) as long as banks are permitted to engage in insurance

underwriting activities, the insurance companies should also be permitted to engage in banking activities since it significantly decreases an insurance company's risks, although bankruptcy risk increases but not significantly (Chapter six). Furthermore, there may be potential economies of scale and economies of scope that may decrease bankruptcy risk which need to be tested separately.

In the first part of the thesis, we found that traditionally banks and insurance companies enjoyed very close links. But during late 80s the situation changed dramatically¹. Banks became more aggressive in entering insurance business. They entered not only in insurance distribution but also in core insurance business, i.e. underwriting of insurance business. This is a serious threat for the traditional insurance companies. On the other hand, insurance companies have not made any significant response to banks' action. Banks have still their monopoly power in the core banking activities, i.e. taking deposits, money transmission services, lending of money etc. We, therefore, have developed a qualitative model of 'assurancebank' for insurance companies in order to provide a defensive strategy as counter response. This is reported in Chapter three. However, in the next paragraphs, we summarise the findings in chapter by chapter.

Chapter two examined the recent development in banking industry. Here we develop *bancassurance* model and attempt to answer four questions. How do banks enter into insurance business? How does *bancassurance* work at branch level? Who are the main players in this field in the EU market? And how well are they performing in this new area? Banks do not use single or same entry strategy.

Different banks adopt different entry strategies available to them. These are de novo entry, formation of holding companies, joint venture between a bank and an insurance company, strategic alliance for joint sales or simply equity holding. We have found that all the major European banks have entered into insurance business in different capacities². But we did not further investigate as to which entry was most suitable for banks or the merits and demerits of each entry strategies. This is probably one of our limitations in the thesis. However, we generalised the bancassurance process, i.e. how the system of bancassurance works at banks branch level. This is based on previous case studies and our personal interviews at branch level. We believe this will add to the literature as to how the system works. We have also investigated the main bancassurance players in Europe through a long time consuming manual search that is one of the hardest task in this thesis. The results of this search, i.e. *creating data sample* as well as *collecting accounting data* for these sample, is one of our main contribution in this thesis. These data can be invaluable for further research and development and some of the data were used in Chapter five for econometric analysis. Furthermore, we measured the bancassurance companies performance through a simple analysis. Although the bancassurance companies market share (in distribution) in life assurance market is significant, they do not have significant market share in general insurance business. This is because banks are very much interested in life assurance business, not in the general insurance business, whereas banking

¹ Factors that affect this dramatic changes are considered in Chapter four.

² Specifications are reported in Chapter two.

products have more links with general insurance products than life assurance products³.

Chapter three examined the recent development in the insurance industry. This was opposite to chapter two. In this chapter, we develop *assurancebank* model and differentiate between *bancassurance*, *assurancebank* and *allfinanz*. We believe this comparison will be helpful to correct the common mistake in the literature. We have created assurancebank data from the European context that can be invaluable for further research and development on this crucial issue. In our investigation in this chapter, on the insurance companies' diversification into banking activities, we found that the insurance companies are less aggressive than the banks in cross-business activities. However, the insurance companies have taken an alternative strategy as a strategic response. Instead of direct competition with banks by offering banking services, most of the insurance companies are becoming more direct marketing oriented to minimise costs in order to survive. We have, therefore, developed a qualitative model of assurancebank in this chapter as a direct strategic response to banks. We also tested the model from the regulatory perspective and from the risk perspective. Both tests supported the model.

The logic for bancassurance is that banks by using their country wide branch network with huge number of employees can market insurance products in addition to and with banking products to a vast customer base, and, thus, might benefit from scale and scope economies. However, banks have little success in bancassurance in the sense that the bank staffs are not capable enough to offer insurance business since insurance products require a very special technical knowledge and skills.

³ For details please see Chapter four.

Admitting this, banks took professional insurance people for insurance business like the traditional insurance companies. However, costs therefore would increase. Moreover, running a highly costly branch network (compared to insurance agency office) would also increase insurance unit cost. However, this cost issue should be tested separately from a bancassurance perspective.⁴

Chapter four examined the reasons for ‘bancassurance’ and ‘assurancebank’. In this chapter, we have found how strongly banks and insurance companies are dependent on each other, which implies cross-section activities. Therefore, we found that much of banking products are related to insurance products (mortgage and life assurance) and vice versa. For instance, financial institutions insurance, credit insurance, mortgage indemnity insurance, marine insurance, mortgagees interest insurance, employers liability insurance, officers and directors liability insurance, life and pension plan etc are frequently taken out by banks as an assignee or via bank customers. On the other hand, bank account, direct debit for insurance premium, insurance companies staff’s salaries and commissions, foreign exchange dealing (for international claims settlement etc), investment, short term lending etc are frequently taken out by insurance companies. Such strong links may influence them to diversify towards each other’s arena if the regulation permits. We have also found, in this chapter, some incentives for banks as well as insurance companies to diversify towards each other. For instance, branch/agency network, vast number of employees, IT and information, advertisement etc areas there is a strong scope for the existence of economies of scale and scope. Such potential cost savings may help to keep/gain the competitive market position. Further more, the

⁴ Dinenis and Chang (1998) found weak scope economies in examining UK data.

implementation of the Treaty of Rome (1957) directly and indirectly forced European regulators to liberalise the market in order to (i) create greater competition in the market so that customers can get competitive lower prices and better quality of services; (ii) to integrate and harmonise the market to achieve the 'single market' theme in Europe; and more importantly (iii) to decrease bankruptcy risks (this is tested empirically in chapter five and six) by allowing diversification. As the banking and insurance industries are highly regulated and are kept separate traditionally, we looked in detail at the regulatory issues with regard to bancassurance and assurancebank that too influence banks and insurance companies to diversify towards each other. After highlighting the traditional regulatory system of banks and insurance companies (both individual European countries and the EC directives), we investigated the changing regulation between banks and insurance companies and the regulators motivation for change. We have found that all the EU countries have liberalised their national regulation of separation of banking and insurance business. The EC directives also moved into the same direction. The motivation of the regulators was to create the motto of 'one stop financial shopping', creating greater competition in the European financial market, and reducing the financial companies bankruptcy risks by allowing diversification (mentioned earlier). But we found that this 'supermarket motto' has created some new problems for them, i.e. regulatory and supervisory activities. In a financial group, the banking part is regulated and supervised by the banking supervisors, usually a country's central bank, and the insurance part of the same group is regulated and supervised by the government's trade department. This dual regulatory system has created some loopholes for these financial conglomerate firms, such as double gearing, contagion risk, lack of information of intra-group

transitions etc. in prudent supervision. We have argued for a single regulatory system in order to overcome some of these problems as long as the banking and insurance cross-business activities are permitted. We have also found that (Chapter five) the bankruptcy risks increase instead of decreases that contradict the regulatory authorities' predicted decision.

Chapter five and six was our econometric work. In Chapter five, we tested our first hypothesis, i.e. the return and risks effects of the banks' diversification into various insurance activities. Based on the European data (data were created in chapter two), we examined the impact on returns and risks effects of European banks' diversification into life assurance underwriting, general insurance underwriting, and insurance broking activities. We examined pre-merger activities and post-merger activities in terms of return and risk effects over the six years period from 1991-1996 and we have found some interesting results. The pre-merger analysis between the banks and different insurance companies (owned by these banks) showed that life assurance and general insurance underwriting companies are more risky than banking business. Even insurance broking is more risky than banking but not significant. However, insurance broking is more profitable than banking. Life assurance underwriting as well as general insurance underwriting is less profitable than banking but not significant. (Table 5.2). In the post-merger analysis, we found that banks significantly increase their risk in underwriting of life as well as underwriting of general insurance business. Expansion in life underwriting significantly increases returns but the effect on return from expanding in general insurance underwriting is not significant. The most profitable expansion is into insurance broking business since our results indicate a significant positive effect on return with no adverse effects on

risk. This suggests that the cross-business distribution activities should be permitted and special consideration should be given in allowing the cross-business underwriting activities in order to reduce the probability of bankruptcies.

Chapter six is the opposite of Chapter five. This tested the second hypothesis, i.e. the impact of the return and risks effects of insurance companies' diversification into banking business (i.e. assurancebank strategy). Over the period of six years investigation from 1991-1996, we also found some interesting results here. In our pre-merger analysis in this assurancebank strategy, it is shown that banks have significantly lower risk than insurance companies in terms of σ risk measurement. However, returns between insurance and banking do not have a significant effect (Table 6.2). In the post-merger analysis, the results show that the insurance companies bankruptcy risk although increases slightly, other risk measurement indicates significant risk reduction and the return in this case does not have significant effect (Table 6.3 and 6.4). Since the returns are not significantly negative, and at the same time, since the risk decreases significantly, the insurance companies, from a firm viewpoint, may adopt assurancebank strategy as a defensive response as long as the banks are permitted to engage in insurance underwriting activities.

We have mentioned earlier that the banks are more aggressive than the insurance companies in cross-business activities. Banks have entered into core insurance business, i.e. underwriting of insurance. This is a serious threat to insurance companies. On the other hand insurance companies have not significantly responded to the banks' reactions. In the core activities of banks like taking deposits, money transmission services etc., banks still have the monopoly. The existence of insurance companies in the core-banking activities is not significant. We have found that almost

all the commercial banks now have life assurance underwriting subsidiaries, but a few banks have a general insurance underwriting subsidiary. Even those who have general insurance underwriting subsidiaries, underwrite very simple general insurance products like household insurance, motor insurance, accident and health insurance. The large exposures like marine, aviation, still insurance companies have the monopoly. In this case, bankers are still bankers and insurers are still insurers.

7.3. POLICY RECOMMENDATIONS

This thesis makes some policy recommendations based on the research findings. The recommendations can be drawn from a number of perspectives, in particular from the banks' perspective, from the insurance companies perspective, from the regulatory authorities' perspective and above all from the public policy perspective.

The main questions we asked were that should banks be permitted in insurance business? If so in what capacity, distribution only or/and underwriting? And, in what sector, life assurance or/and general insurance business? Should insurance companies be permitted to engage in banking? The main objective of regulators are to protect the companies from bankruptcies, thus, to safe the individuals savings and investments. As to whether banks be permitted to engage in insurance business, or vice versa, these results will be useful to the regulatory authorities for further decision making. Based on our findings, we can recommend that if the objective of public policy is to minimise the risk of bank/insurance company's failure, then our results suggest that European banks should be restricted to acquiring life assurance and general insurance underwriting companies. But they may be permitted to acquire insurance broking companies on the ground that though the risk increases in engaging in insurance broking business, this does not

have a significant effect, instead the returns significantly increase when banks engage into insurance broking. On the other hand, insurance companies should be permitted to engage in banking business (at least) as long as banks are permitted in engaging banking activities. This is because, although the bankruptcy risk increases slightly, the other risk measurement (σ) indicates significant risk reduction, which strongly support the consistent returns of the insurance companies. However, underwriting activities in both cases should be restricted. Holifield (1994), President of the Insurance Supervisory Office of Berlin, also suggested for limited use of liberalisation.

Our *recommendation to banks* are that banks should concentrate on insurance distribution in addition to their core business, i.e. banking business. Because our results suggest that only insurance broking is profitable and is at the same time a safer arena. Banks should spend more money on staff training for insurance operations (marketing) since it requires special technical knowledge. Professional bodies like the Chartered institute of Bankers, the Chartered Insurance Institute in the UK and similar other European countries professional bodies should thoroughly revise their syllabus structure to meet their clients' need. In their professional syllabus, the core banking activities and core insurance activities should be made compulsory for both professional bodies' professional exams, so that, staff can cope with the newly amalgamated environment. Life assurance underwriting as well as general insurance underwriting by banks does not show a positive return. One may argue that our sample period is in too early a stage⁵. But underwriting insurance, especially life assurance underwriting, by banks date back to 70s and 80s. Therefore, a new

⁵ our sample period is from 1991 to 1996. Most of the underwriting activities started during late eighties or early nineties.

organisation generally should make profit after fifth year. There may be another reason for this. The combination of banking with insurance might not be an efficient set of businesses (especially underwriting) due to their nature of business and complex structure of organisation forms.

Our *recommendations to insurance companies* are that insurance companies should response to banks as long as the banks are permitted to conduct core insurance activities, i.e. underwriting of insurance. Although no significant change of returns, the significant reduction of σ strongly supports the consistent returns of the insurance companies. Furthermore, as a significant number of customers are moving towards banks- insurance services due to *one stop financial shopping*, insurance companies in order to retain existing customers should adopt the assurancebank strategy.

Banks as well as insurance companies are regulated separately, banks by the central banks and the insurance companies by the government trade department. Due to the heavy amalgamations of banking and insurance business, there should be a single regulatory body to overcome the dual regulatory problems as long as this cross-business is permitted, and it will, therefore, be easy for prudent supervision by the supervisory authorities.

According to industrial economic theory, people in general want the best products with a relative cheap price. Allowing cross-business distribution and tightening the cross-business underwriting will facilitate one stop financial shopping for consumers and at the same time minimise the bankruptcy risks of banking and insurance companies.

7.4. LIMITATIONS OF THIS THESIS AND SUGGESTIONS FOR FURTHER RESEARCH

Allowing banking insurance cross-business raise four fundamental questions. These are - does bankruptcy risk increase when banks diversify into insurance business? Or do the scale and scope economies exist if banks diversify into insurance business? On the other hand, does bankruptcy risk increase when insurance companies diversify into banking business? Or do the scale and scope economies exist if insurance companies diversify into banking business? We conducted both bankruptcy and profitability test but one of the main limitations of this thesis is that this thesis did not considered the potential benefit of scale and scope economies for banks and insurance companies cross-section business. Banks' diversification into insurance business or vice versa may be potential beneficial in terms of cost efficiency. Diacon (1990c), and Dinenis and Jung (1998) conducted test from the UK perspective. Others may conduct the test of the existence of scale and scope economies of banks/insurance companies in European context.

We conduct simulation test on insurance company's diversification into banking business due to the lack of data, since insurance companies have started very recently (mid nineties) to engage in banking business. Like our bancassurance test, other researchers may undertake research with actual data in several years time to show the actual impact.

We have found banks as well as insurance companies adopt various entry strategies for cross-section business (like de novo entry, mergers and acquisitions, strategic alliance etc.), but we did not consider which type of entry is most suitable for banks or insurance companies. One may undertake research as a comparative study on this issue.

We have excluded those banks that have only tied alliance with insurers in our empirical test. Therefore, we are unable to make recommendation on to them.

We did not investigate pricing policies. Therefore, we do not know who provides the same products cheaply banks or insurance companies since both provide all sorts of personal line products such as pension, life assurance, mortgage and loan etc. From consumer point of view, one might undertake research on this issue as to where the customers are better off.

In case of bancassurance activities, we did not test problems of bancassurance operation at bank branch level. There might be cultural clash, regulatory restriction, lack of technical skill etc. Someone may undertake research through a survey method to test this empirically. However, as a first attempt from the European context, we believe this thesis will be the basis for further research in the area of bancassurance and assurancebank.

THE END

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APPENDIX: I

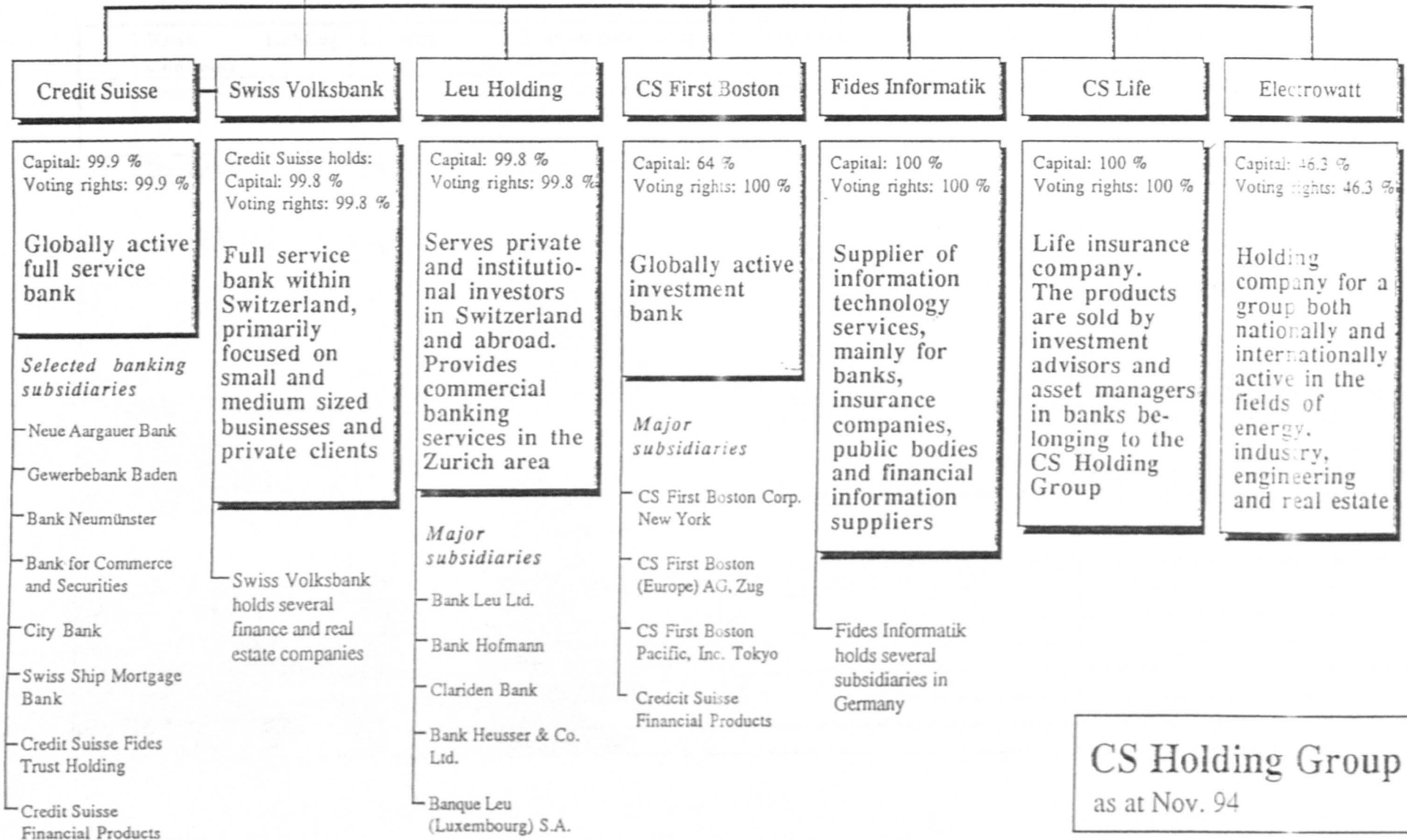
List of top 100 European banks

1	Credit Agricole	51	Caja de Ahorros y Pen de Barcelona
2	HSBC Holdings	52	Norddeutsche Landesbank
3	Union Bank of Switzerland	53	Kreditbank
4	Deutsche Bank	54	LandesBank Berlin Girozentrale
5	Credit Lyonnais	55	Caja de Madrid
6	ABN-AMRO Bank	56	Credit Commercial de France
7	Banque National de Paris	57	Credit Local de France
8	CS Holdings	58	Bank of Scotland
9	Compagine Financiere de Paribas	59	Credit Communal de Belgique
10	Swiss Bank Corporation	60	Banque Brussels Lambert
11	Barclays Bank	61	Creditanstalt-Bankverein
12	National Westminster Bank	62	Standard Chartered
13	Rabobank Nederland	63	Landeskredit Baden-Wurttemberg
14	Societe Generale	64	Caixa Geral de Depositos
15	Dresdner Bank	65	Allied Irish Bank
16	Westdeutsche Landesbank Giro	66	BHF Bank
17	Groupe Caisse d'Epargne	67	Cassa di R di Verona Vicenza, B & A
18	Cariplo	68	Banco Populair Espanol
19	San Paolo Bank Holding	69	Nordbanken
20	Banco Bilbao Vizcaya	70	Mediobanca
21	Abbey National	71	SG Warburg Group
22	Banca di Roma	72	Unidenmark
23	Lloyds Bank	73	Banca CRT
24	Commerzbank	74	Unitas
25	Argentaria	75	CERA
26	Bayerische Hypo & Wechsel-Bank	76	Bank Nederlandse Gemeenten
27	Banco Central Hispanoamericano	77	Swedbank
28	Banca Nazionale del Lavoro	78	Banco di Sicilia
29	Istituto Mobiliare Italiano	79	Zurcher Kantonalbank
30	Internationale Nederland Bank	80	Berliner Bank
31	Bayerische Vereinsbank	81	Banca Popolare di Milano
32	Banco Santander	82	Landesbank Schleswig-Holstein Giro
33	Banca Commerciale Italiana	83	ASLK-CGER Bank
34	Monte dei Paschi di Siena	84	Credit National
35	Groupe des Banques Populaires	85	Greek Post Office Savings Bank
36	Kreditanstalt fur Wiederaufbau	86	Bank of Ireland
37	Bayersche Landesbank Girozentrale	87	Hamburger Sparkasse
38	DG Bank	88	Wustenrot Holding GmbH
39	Den Danske Bank	89	Kansallis-Osake-Pankki
40	Generale Bank	90	SudwestLB
41	Skandinaviska Enskilda Banken	91	Hamburgische Landesbank
42	Royal Bank of Scotland	92	VSB Groep
43	Banco di Napoli	93	Banco Comercial Portugues
44	TSB Group	94	Helaba-Landes Hessen-Thuringen
45	Banesto - Banco Espanol de Credito	95	Deutsche Pfandbrief-und Hypo
46	Svenska Handelsbanken	96	Banca Popolare di Novara
47	Union Europeenne de CIC	97	Banco Ambrosiano Veneto
48	Credito Italiano	98	Schroders
49	Banque Indosuez	99	Grupo Banca March
50	Bank Austria	100	Girocredit

Source: The Banker, September 1994

CS Holding

Swiss Volksbank Management
is subordinated to CS Holding



CS Holding Group
as at Nov. 94

APPENDIX: III

European Bancassurance Companies 1996

	Bank Holding Company	Country	Life Assurance Company	General Insurance Company	Broking Company
1	Abbey National	UK	Abbey National Life Scottish Mutual Assurance Society Ltd.	Abbey National-Commercial Union, Carfax Insurance Ltd.	Abbey National Insurance Consultant Ltd., Future Insurance Services Ltd. (GN INSU.)
2	Barclays Bank	UK	Barclays Life		Barclays Insurance Services Ltd. Barclays International Insurance Services Ltd.
3	Natwest Group	UK	Natwest Life		National Westminster Insurance Services Ltd.
4	Lloyds Bank	UK	Lloyds Abbey Life Ambassador Life Lloyd Bowmaker Black Horse Life		Lloyds Bank Insurance Services Ltd.
5	Midland	UK	Midland Life	Midland General Insurance Ltd.	Midland Bank Insurance Services Ltd.
6	Royal Bank of Scotland	UK		Direct Line	RBS Insurance Services Ltd.
7	Bank of Scotland	UK	Standard Life*		Bank of Scotland Insurance Consultant Ltd.
8	TSB Group	UK	TSB Life TSB Pension Target Life	TSB General Insurance Ltd.	TSB Insurance Services Ltd.
9	SG Warburg Group	UK	Mercury Life Assurance		
10	Allied Irish Bank	UK	Irish Life		
11	Bank of Ireland	UK	Lifetime*		
12	Alliance & Leicester	UK	Alliance & Leicester Life		
13	Nationwide	UK	Nationwide Life		
14	Leeds Permanent	UK	Leeds Life		
15	Yorkshire Bank	UK	Yorkshire Life*		

16	Hansard Financial Trust Co	UK	Liberty Life Assurance		
17	First National Finance Corp	UK	First National Life Assurance		
18	Britannia B. S	UK	Brittania Life*		
19	Halifax	UK	Halifax Life		Robinson Insurance Services Ltd., Halifax Mortgage Services (Insu. Brokers) Ltd.
20	Woolwich	UK	Woolwich Life		
21	National & Provincial	UK	N & P Life		National & Provincial Insurances Ltd., N & P Independent Financial Consultants Ltd., N & P Insurance and Investment Services Ltd.
22	Hill Samuel	UK	Hill Samuel Life Gisborne Life		
23	Hambros	UK	Hambro Assured		Hambro Legal Protection Ltd., Berkeley (Insurance) Ltd. (80%)
24	HFC Bank	UK	Hamilton Life	Hamilton Insurance Co	
25	Clydesdale Bank		National Australia Life		Clysdale Bank Insurance Brokers Ltd.
26	Credit Agricole	France	Predica Life(1986)	Pacifica Non-Life (1990)	
27	Credit Lyonnais	France	CL Assurance		
28	Banque Nationale de Paris	France	Natiovie, Assuvie*, Natio Assurances		
29	Caisses D'Epargne	France	Ecureuil Vie (1988)		
30	Credit Municipal	France	Assurances du Griffon (1987)		
31	Credit Commercial de France	France	Erisa-Vie (1989)		
32	Credit Populaire	France	Groupe Fructivie (1982), Prosperite (1989), Fructivie, Prevoyance		
33	Sovac	France	Assupar Vie, Vie Plus		
34	Groupe Paribas	France	Cardif Societe Vie, Helios Societe Vie		

35	Groupe Indosuez (Banque la Henin)	France	La Henin Vie		
36	Union Europeene de CIC	France	Socapi (1985)		
37	Credit Lyonnais	France	UDAF Life, Elysis	Medical de France-vie	
38	Societe Generale	France	Sogecap, Sogenal Vie		
39	Deutsch Bank	Germany	DB Leben		
40	Commerzbank	Germany	DBV		
41	Generale Bank	Belgium	Alpha Life		T. C. D. Thibut-Colson-Dene
42	Kreditbank	Belgium	OMNIVER-VIE		Almaver N.V.
43	Credit Commercial de Belgium	Belgium	Mega Life	Mega- Non-Life	
44	CGER	Belgium			
45	Assubel	Belgium			
46	Argenta	Belgium			
47	IPPA Banque de Epargne	Belgium	Royal Belge		
48	Metropolitan Bank	Belgium	Groupe AG		
49	SEFG	Belgium	GAN		
50	Banque Commerciale de Bruxelles	Belgium	Growpe Josi		
51	Banque Brussels Lombert	Belgium	BBL Life, BBL Life Luxembourg SA (99.96%)	BBL Insurance	BBL Insurance Brokerage SA
52	ANYHP	Belgium	ANYHP Life		
53	Baltica	Denmark	Baltica insurance		
54	Banque Generale de Luxembourg	Luxembourg	BGL Vie		
55	Banco Commercial Portugues	Portugal	Occidental		
56	Monte de Pasenchi	Italy	Ticino, Montepaschi Vita		
57	Banca Nazionale de Lavoro(BNL)	Italy	Lavoro Vita (1986)		

58	BPN	Italy	SAI		
59	San Paolo	Italy	Polaris Vita	CIDA, SIPEA	
60	Istituto Mobiliare Italiano	Italy	Fideuram Vita (1984)	Fideruam Danni (1989)	
61	Monta del Paschi de Siena	Italy		Ticino(1989)	
62	Banco Bilbao Vizeaya	Spain	Euroseguros, Plus Ultra, DAPA	Aurora Polar,	BBV Brokers
63	Banco Espagnol de Credit	Spain	La Union yel Fenix Espagnol		
64	Banco Central	Spain	Banco Vitalicio, Navarra Nacional-Hispinieay Vasco,		
65	Cajas de Ahorro	Spain	Caser		
66	Banco de Santander	Spain	Cenit		
67	Banco Zaragozano	Spain	Uniseguros		
68	Banco Itispano Americano	Spain	La Estrella		
69	Allianz-RAS	Spain	Cresa, Ercos Adriatica Y Allianz		
70	PK Banken	Sweden	Livia		
71	ABN-AMRO	Netherlands			ABN/AMRO Verzekeringen
72	ING Group	Netherlands	ING Insurance	NRG Fenchurch General Insurance	
73	RABO Bank	Netherlands	Interpolis		
74	VSB	Netherlands	AMEV	Bishopgate Insurance PLC	
75	Banco Americano	Spain			Hispano Americano

APPENDIX: IV

List of sample firms for Bancassurance Test

A. European Banks

1	Abbey National PLC	24	Halifax PLC
2	ABN-AMRO Holdings	25	Hambros
3	Allied Irish Banks PLC	26	Istituto Mobiliare Italiano
4	Bancaire, CIE	27	Kreditbank
5	Bancop Bilbao Vizaya	28	La Caixa
6	Banco Central Hispanoamericano	29	Lloyds Bank
7	Banco Commercial Portugues	30	Lloyds TSB Group
8	Bank of Scotland	31	Midland Bank
9	Banque Paribas	32	Montei di Paschie Siena
10	Banque Populaires	33	National Westminster Bank
11	Barclays Bank	34	National & Provincial Building Society
12	Banca Nazionale del Lavarò	35	Paribas, CIE Financiere
13	Britannia Building Society	36	Rabobank
14	Caripolo	37	Royal Bank of Scotland
15	Credit Communal de France	38	San Paolo
16	Clydesdale Bank	39	Skandinaviska Enskilda Banken
17	Co-operative Bank (UK)	40	Societe Generale
18	Credit Agricole	41	Svenska Handelsbanken
19	Credit Lyonnais	42	SG Warburg
20	Credit Suisse	43	TSB Group
21	Deutsche Bank	44	Woolwich PLC
22	First National Finance Corp	45	Yorkshire Bank
23	Fleming, Robert		

B. Bank's Own Life Underwriting Companies

1	Abbey Life	21	Gisborne Life
2	Abbey Life Pension	22	Hambro Assured
3	Abbey National Life	23	Handelsbanken Liv
4	Ambassador Life	24	Hill Samuel Life
5	Assurances Federals Vie	25	Interpolis
6	Barclays Life	26	La Estrella
7	Black Horse Life	27	Lloyds Bowmaker
8	BNL Vita (Lavarò Vita)	28	Mercury Life
9	Britannia Life	29	Midland Life
10	Caixa Vida	30	Monte di Paschi Vita
11	Cari Vita	31	N & P Life
12	CS Life	32	Ocidental
13	DB Leben	33	Omniver Vie
14	Erisa	34	Predica Life
15	Euroseguros	35	Royal Scott Assurance
16	Fideuram Vita	36	San Paolo Vita
17	First National	37	S-E Banken Life
18	Fleming Life	38	Sogecap
19	Fructi Vie	39	TSB Life
20	Generali	40	Woolwich Life

C. Bank's Own General Insurance Underwriting Co

1	Aurora Polar
2	Direct Line Insurance Co Ltd
3	Fideuram Assicurazioni
4	GAN
5	NCM Insurance
6	Pacifica
7	Pinnacle Insurance
8	Segurocaixa
9	Ticino
10	TSB General Insurance Ltd
11	Omniver Iard
12	UAF

D. Bank's own Insurance Broking Co

1	Agenciaixa
2	Bank of Scotland Insurance Services
3	Barclays Insurance Services Ltd
4	BBV Brokers
5	Clydesle Bank Insurance Brokers Ltd
6	Co-operative Bank Financial Advisers Ltd
7	Halifax Mortgage (Insurance Brokers) Services Ltd
8	Lloyds Bank Insurance Services Ltd
9	Luiz Megre Beca
10	National Westminster Insurance Services Ltd
11	Yorkshire Bank Financial Services Ltd

APPENDIX: V

List of sample firms for Assurancebank Test

European Large Insurance Company		<i>European Medium Banks</i>	
1	Aegon NV	1	Allied Irish Bank
2	Allianz AG	2	Baden Wurttembergisch
3	Assurances Generale de France	3	Banca Intesa
4	AXA UAP SA	4	Banco Commercial Portugues
5	Commercial Union PLC	5	Banco di Sardegna
6	FINAXA	6	Banco Espirito Santo
7	GAN, STE Centrale DU	7	Banco Popular Espanol
8	Generali	8	Banco Portugues
9	ING Group	9	Banque Cantonale Vaudc
10	Legal & General Group	10	Banque Generale du Luxembourg
11	Munchener Ruckversich	11	Banque Nationale de Belgique
12	Prudential Corporation	12	BG Bank
13	Royal & Sun Alliance Insurance PLC	13	BHF Bank
14	Schweizerische Leben	14	BNA Banca Nazionale del
15	Suez, CIE DE	15	BPI Sgps
16	UAP, CIE	16	Den Norske Bank
17	Winterthur ste Suiss	17	Erste Bank der Osterren
18	Zurich Insurance Co	18	Espirito Santo Financial
European Medium Insurance Company		19	Istituto Mobiliare Italiano
1	Allied Dunbar Assurance Co	20	Mediobanca
2	AMB	21	Merita PLC
3	AXA Colonia Konzern	22	Natexis
4	Baloise Holding	23	Nordbanken Holdings
5	Commercial Union France	24	Schweizerische National
6	Eagle Star Holdings		
7	General Accident PLC		
8	GRE		
9	Lloyds Abbey Life		
10	Royal Belge		
11	RSA		
12	Skndia Insurance Co		
13	Sun Life Corporation		

- 14 Swiss Reinsurance Co
- 15 Victoria Holding

European Small Banks

- | | | | |
|----|------------------------------|----|-----------------------------|
| 1 | Anglo Irish Bank Corporation | | |
| 2 | Banca Agricola Milanese | | |
| 3 | Banca Fideuram | 19 | Gitthard Bank |
| 4 | Banca Toscana | 20 | Graubundner Kantonalbank |
| 5 | Banco Atlantico | 21 | Household International |
| 6 | Banco de Andalucia | 22 | ICC Bank |
| 7 | Banco Pastor | 23 | Jyske Bank |
| 8 | Banco Zaragozano | 24 | Liechtensteinische Landes |
| 9 | Bank fur Karnten und Ste | 25 | Neue Aargauer Bank |
| 10 | Bank Slaski | 26 | Okobank |
| 11 | Bankinter | 27 | Robert Fleming |
| 12 | Banque Cantonale du Jura | 28 | Rothschilds Continuation |
| 13 | Basellandschaftliche Kan | 29 | Vereins und Westbank |
| 14 | Basler Kantonalbank | 30 | Verwaltungs und Privat Bank |
| 15 | Berner Kantonalbank | 31 | Yorkshire Bank |
| 16 | Cetelem | 32 | Zuger Kantonalbank |
| 17 | Credit General | | |
| 18 | Clydesdale Bank | | |

APPENDIX: VI.

Sample letter to European Insurance regulators

The Controller
ANIA
20122 Milano
Piazza S. Babila 1
Italy.

The 28th November 1997

Frobisher Crescent
Barbican Centre
London EC2Y 8HH

Switchboard: 0171-477 8000
Direct Line: 0171-477
Fax: 0171-477 8990

Dear Controller,

The Department of Investment, Risk Management & Insurance of the City University Business School, has undertaken a PhD research project on the 'Interface of Insurance and Banking in European countries'. One of our objectives is to test the riskiness of 'bancassurance/allfinanz' firms as to whether they increase or decrease their risks (bankruptcy risk) when banks diversify into insurance (Life, Non-Life, Insurance Broking) business.

We shall be highly grateful if you would provide us the enclosed listed *insurance companies' Annual Returns to Istituto per la Vigilanza Sulle*, from 1991 to 1996 (or all the years since they started if less than this period). If you are interested we will send you a copy of our results as a complimentary.

However, in the mean time, if there is any charge for this, please let me know, stating to whom the cheque should make payable.

Thank you in advance for your kind co-operation and participation in this research.

Yours sincerely,

(Signature)

M. Nurullah
Department of Investment, Risk Management & Insurance

Appendix. VI. (Cont.)

List of Insurance (bancassurance) Companies, Italy

Insurance companies	Parent Banks
1. Lavoro Vita	Banco Nazionale de Lavoro
1. Fideuram Vita	Istituto Mobiliare Italiano
2. Fideuram Danni	
1. San Paolo Vita	San Paplo
1. Cari Vita	Cariplo
1. Montepaschi Vita	Monte dei Paschi di Siena
2. Ticino	

APPENDIX: VII.

Sample letter written to individual European
parent banks

Frobisher Crescent
Barbican Centre
London EC2Y 8PH

Switchboard: 0171-477 8000
Direct Line: 0171-477
Fax: 0171-477 8880

The President
Deutsche Bank AG
Taunusanlage 12
60325 Frankfurt
Germany

16th February 1998

RE. Consolidated profit and loss account and balance sheet data from 1991 to 1996.

Dear sir,

The Department of Investment, Risk Management & Insurance of the City University Business School has undertaken a research project on the 'interface of Insurance and Banking in European Countries' which will form a PhD thesis. For this research we kindly request you to send us your insurance subsidiaries (DB Leven and Deutsche Harold) consolidated profit and loss accounts as well as balance sheets from 1991 to 1996.

We have already got the Deutsche Bank's data. No individual company's name will be mentioned in the research but at the end of the results in the thesis we would like to mention the name of all the participant companies.

As you are well aware that banking –insurance interface is currently an issue of intense concern, we believe the out put of this research will be a great help for the decision makers of these industries and the relevant regulators.

If you are interested we will send you a copy of our results as a complimentary.

Thank you in advance for your co-operation in this research.

We are waiting for your reply.

Yours sincerely

Signature
(M. Nurullah)

APPENDIX: VIII.

Sample letter to individual European banks / Insurance subsidiaries

BUSINESS SCHOOL

Frobisher Crescent
Barbican Centre
London EC2Y 8HB

Switchboard: 0171-477 8000
Direct Line: 0171-477.....
Fax: 0171-477 8880

The President
La Henin Vie
14, rue Roquepine
75379 Paris cedex 08.

16th February 1998

RE. Consolidated profit and loss account and balance sheet data from 1991 to 1996.

Dear sir,

The Department of Investment, Risk Management & Insurance of the City University Business School has undertaken a research project on the 'interface of Insurance and Banking in European Countries' which will form a PhD thesis. For this research we kindly request you to send us La Henin Vie's (Subsidiary of Banque Indosuez) consolidated profit and loss accounts as well as balance sheets from 1991 to 1996.

We have already got the Banque Indosuez's data. No individual company's name will be mentioned in the research but at the end of the results in the thesis we would like to mention the name of all the participant companies.

As you are well aware that banking –insurance interface is currently an issue of intense concern, we believe the out put of this research will be a great help for the decision makers of these industries and the relevant regulators.

If you are interested we will send you a copy of our results as a complimentary.

Thank you in advance for your co-operation in this research.

We are waiting for your reply.

Yours sincerely

Signature
(M. Nurullah)

APPENDIX: IX

Sample banks initially interviewed personally (March-April 1996)

- i. Abbey National Plc
- ii. Barclays Plc
- iii. Halifax Plc
- iv. Lloyds Bank Plc
- v. TSB Group
- vi. National Westminster Bank
- vii. Woolwich Plc

APPENDIX: X**Number of Financial Conglomerates**

	Banks, investment undertakings owned by an insurance company	Insurance companies owned by a bank or investment undertaking	Banks, investment undertakings and insurance companies subsidiaries of a common parent undertaking	Others
Belgium	There are no Belgian statistics on the number of financial conglomerates. The OCA is trying to collect some.			
Germany	Approximately 5	Approximately 4	Approximately 2	Exact number unknown
Denmark	1 (Alm. Brand)	2 (den Danske Bank, Bikuben)	0	3 (Baltica, Hafnia, Top)
Spain	There are 28 groups or conglomerates			
	Group Mapfre (2nd in Spain per premium income and own funds)	7: BBV, Central-Hispano, La Caixa, Banesto, Santander, Argentaria and Caxia de Catalana + Caser (parent company= an insurance company controlled by savings banks)		
France	12 banks owned by 9 insurance groups	32 insurance groups owned by 12 banking groups	3 insurance groups owned by parent companies with other financial or industrial participation.	
Greece	1	12 insurance companies owned by 6 banks	3 insurance companies owned by a holding	information not available
UK	17 groups where the principal activity is insurance	26 groups where the principal activity is of the banking type	Insurance undertakings and banks are never , generally speaking , members of a group also containing industrial undertakings. One exceptional: BAT, which controls Eagle Star and Allied Dunbar. Similarly, it is rare for a group to include an insurance company and a broking company. There are however, notable exceptions.	
Italy	8 or 9	Some 20		
Ireland		2	2	
Luxembourg	Generally speaking, there are 4 conglomerates (banks/insurance) meeting the participation criterion. NB. Not covered are foreign conglomerates including Luxembourg subsidiaries of foreign insurance companies.			
Netherlands	7 mixed financial groups principally engaged in insurance.	2 mixed financial groups principally engaged in the banking sector.	3 general mixed financial groups.	
Portugal	1 (Bonanca - 19.17% - VBP (bank))	12	0	One case where a banking group has participation in three insurance companies and two broking companies.

Source: Comit   de European Assurance, Paris, 1993