Annual Industry Checkup: 2018/2019

Investment and Insurance Services in Financial Institutions

CUSO FINANCIAL SERVICES, LP Member FINRA / SIPC
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KEHRER BIELAN RESEARCH & CONSULTING

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Introduction

Since 2012 KBR&C has combined proprietary and industry data to provide an annual review of the health of the investment services industry in banks and credit unions. See page 8 for the catalog of sources.

The data for this year's report cover 2,329 of the banks and credit unions that provide investment services, which collectively manage 11,089 advisors.

Executives who manage investment services inside banks and credit unions can use this report to evaluate their businesses against their peers in the industry.

Product and service providers can use this report to track important trends in the financial institution channel.

Financial institutions not yet offering investment services can assess their prospects for entering the business.

Key Findings

2018 was a year defined by its end. After three quarters of strong market growth, the correction that occurred in the last quarter wiped out the year's gains and most indices ended the year down.

The volatility in the market colored the performance of the bank brokerage industry. The industry has shifted its business model to a considerable extent away from charging commissions for transactions and towards advisory business, charging fees on assets in managed accounts. Many firms benefitted from the strong market, earning basis points on managed assets which increased steadily in value through the first three quarters of the year, in turn generating greater and greater fee revenue.

Given the way that advisory fees are paid, firms did not feel the pain of the market correction until the first quarter of 2019, but the drop in the market effectively eliminated all asset gains on the year. As a result, investment revenue was up sharply year-over-year, while investment assets were essentially flat after the correction.

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Key Findings (cont.)

Revenue grew faster in institutions that own a BD affiliate than those that partner with a third-party broker dealer. Bank-owned broker dealers are further along in the transition to advisory business, relative to the TPMs, generating a greater share of revenue from advisory fees. This gave them a leg up during a year defined by a supercharged market.

But gross revenue per advisor grew faster among the TPM partner institutions than the bank BDs. What happened?

Both groups experienced net attrition of advisors, but headcount dropped more in the TPM partner institutions, boosting average advisor gross production.

Key Findings (cont.)

Because revenue was up while assets remained flat, average revenue on assets improved significantly. The effect was more pronounced in institutions that partner with a third-party broker dealer. While their revenue growth was somewhat slower than the bank BDs, they experienced a larger drop in assets under administration.

Average investment assets per advisor remained essentially flat year-over-year in financial institutions, as both headcount and assets dipped in lock step. But average assets per advisor dipped in the TPM-affiliated institutions as AUA fell more than advisor headcount.

Key Findings (cont.)

The number of banks offering investment services continues to shrink, but so does the universe of US banks, as the industry continues to consolidate. But last year the percentage of banks providing financial advice fell for the first time since 2008.

While the number of banks with investment services has fallen, those in the business have generally gotten bigger. That trend also stalled in 2018.

On the other hand, while the number of credit unions is also shrinking through consolidation, and a smaller proportion of credit unions offer investment services, that proportion continues to grow robustly.

Key Findings (cont.)

Given the ways in which the volatility in the market impacted the various metrics we tend to use to assess the health of the industry and the performance of individual firms, there is a risk that the lessons of 2018 could be misinterpreted.

Despite revenue being up year-over-year, there are many troubling signs to be taken from this report.

- Advisor headcount, a key driver of growth, was down somewhat again;
- New net asset acquisition remains modest;
- Even the market-assisted growth in revenue did not match the growth expectations of the top of the house in most institutions;
- After a decade of expansion in which more and more US households could access financial advice where they bank, that progress stalled during 2018.

It was a year that pleased the institutions' CFOs, but was vexing for chief strategy officers.

2018 Industry Trends

Sources of Data

- Kehrer Bielan Annual TPM Survey
  - Virtually covers the universe of banks and credit unions that offer investment services through third party broker dealers
  - Separate reporting for banks and credit unions
- Kehrer Bielan Annual Bank Broker Dealer Survey
- Kehrer Bielan Survey of Investment Services in Credit Unions
- Kehrer Bielan Survey of Investment Services in Regional and Community Banks
- Kehrer Bielan Advisor Compensation Survey
- Kehrer Bielan Flash Surveys of advisor recruiting and retention, management of investment call centers, second story advisors, and changes in annuity distribution
- FDIC Call Report and NCUA data

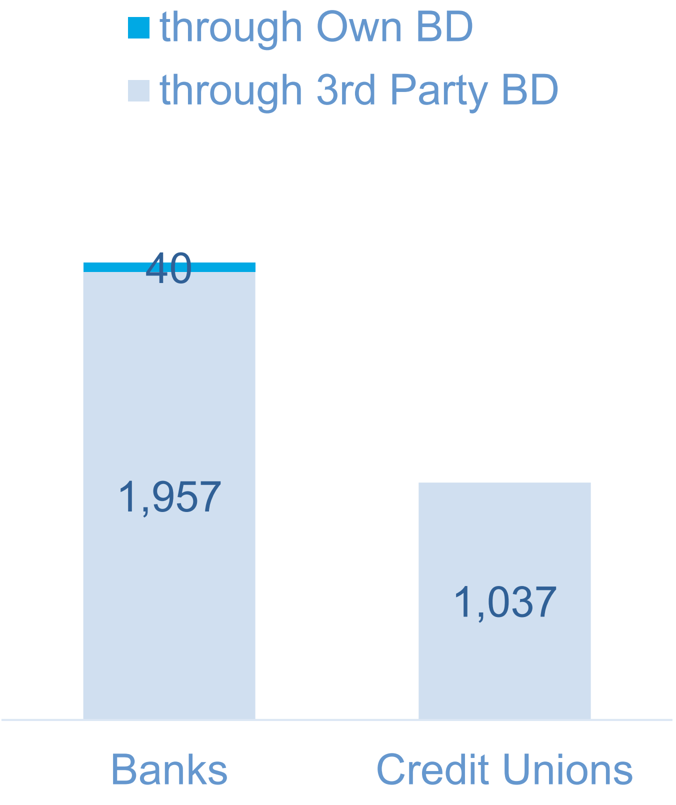
How many banks and credit unions offer investment services?

We estimate that over 3,000 financial institutions are selling investments

- Most provide investment services through a 3rd party broker-dealer; only 40 retail banks do not outsource their BD, down from 42 the previous year.
- Several wholesale and private banks also own BDs.
- FDIC reports 1,399 retail banks with investment services revenue, but data are spotty and appear to undercount the actual number of banks offering investment services.
- Similar regulatory data are not available for credit unions.
- Our research suggests that 1,957 banks and 1,037 credit unions offer investment services through 3rd party BDs (TPMs).

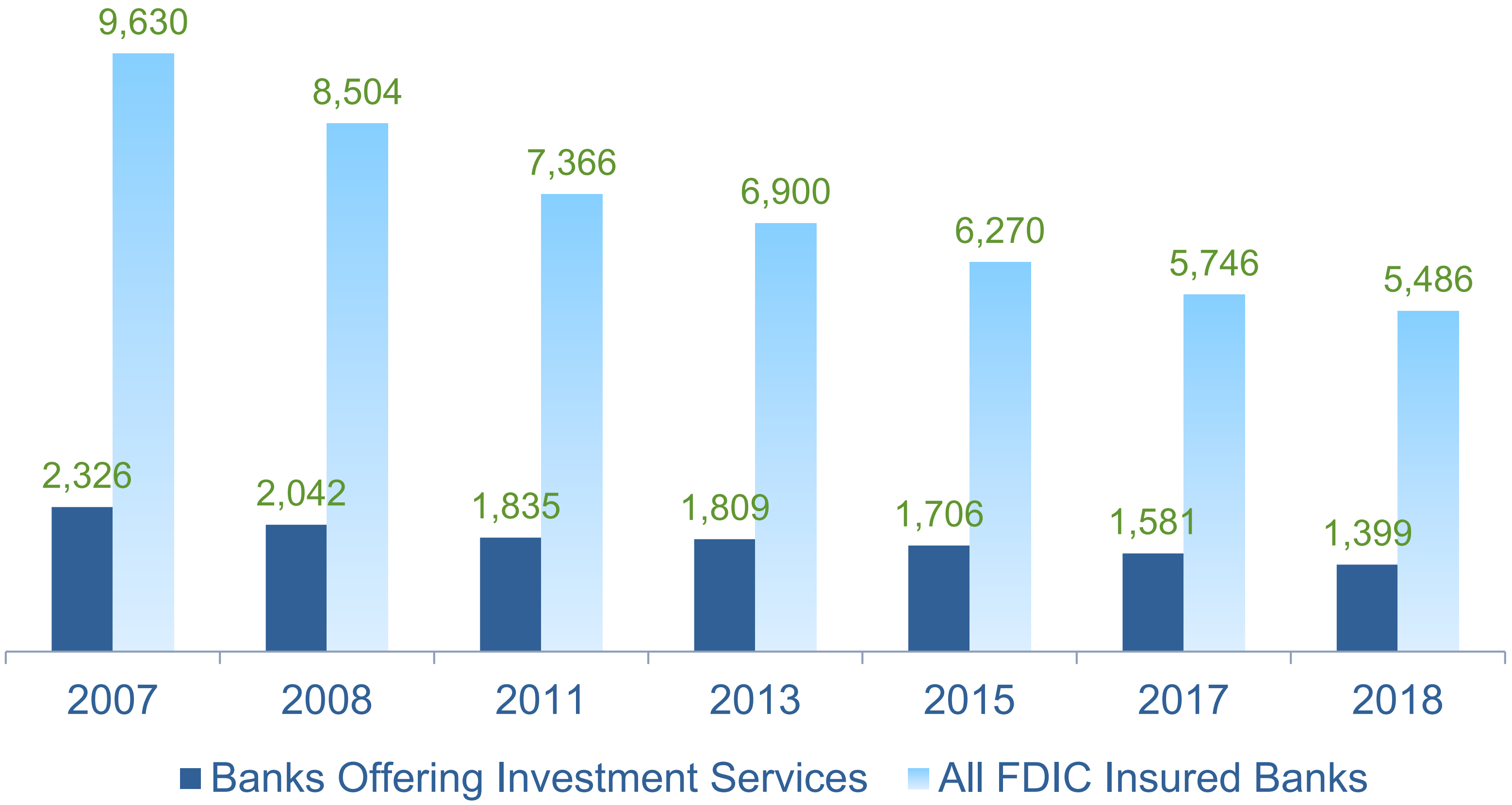
Source:
Kehrer Bielan Annual TPM Survey and proprietary research

Kehrer Bielan's Estimate of Financial Institutions Offering Investment Services



Trends in US *Banks* Selling Investments

According to FDIC data, the number of banks offering investment services continued to decline, but the total number of banks continued to shrink, sometimes faster, as banks consolidate.



Source: FDIC Call Reports and proprietary research

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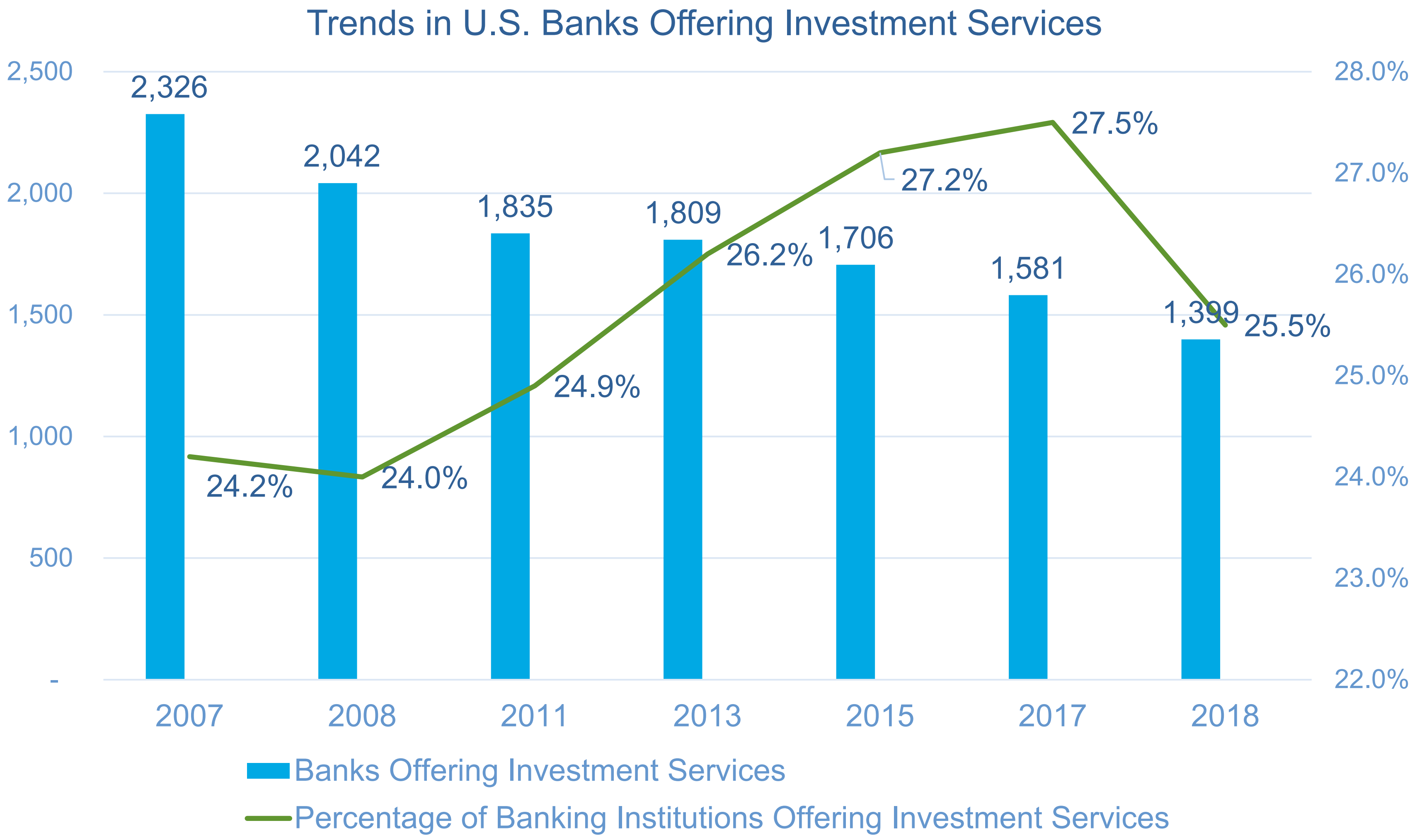
Trends in US *Banks* Selling Investments

The *percentage* of banking institutions offering investment services was down for the first time since 2008.



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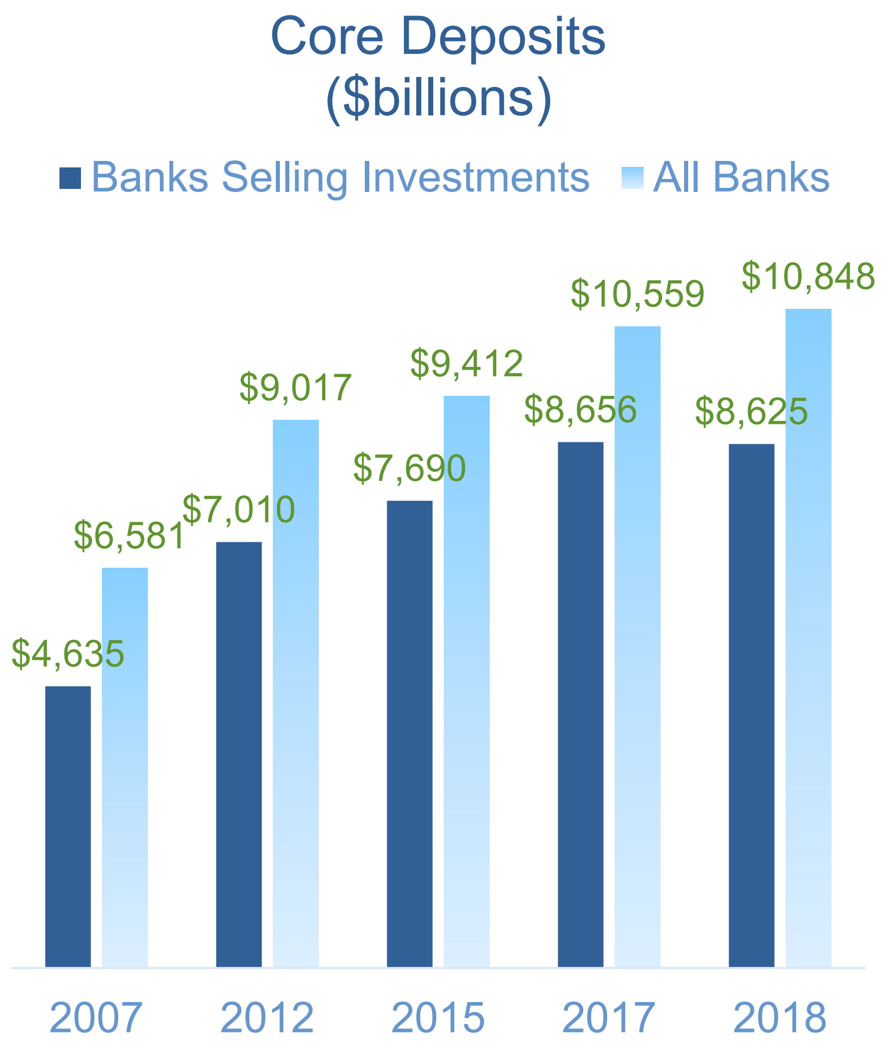
Core Deposits in Banks that Offer Investment Services

While the number of banks selling investments has shrunk, they have been getting bigger, through both mergers and organic growth.

In 2007, the 2,219 banks selling investments had $4.6 trillion in consumer deposits (70% of all core deposits).

In 2018, the 1,399 banks selling investments had $8.7 trillion in consumer deposits (80%), down from 82% the previous year.



Size Distribution of *Banks* Selling Investments

The larger the bank, the more likely it is offering investment services.

Core Deposit Segments	Number of Banks	Banks Selling Investments	Percent of Banks Selling Investments
under $250mm	3,450	436	12.6%
$250-$500 mm	934	362	38.8%
$500mm-$1b	511	243	47.6%
$1b-$5b	418	242	57.9%
$5b-$10b	66	47	71.2%
over $10b	98	69	70.4%
Total	**5,486**	**1,399**	**25.5%**

Source: FDIC and proprietary research

The Largest Banks Own Their Own Broker Dealer

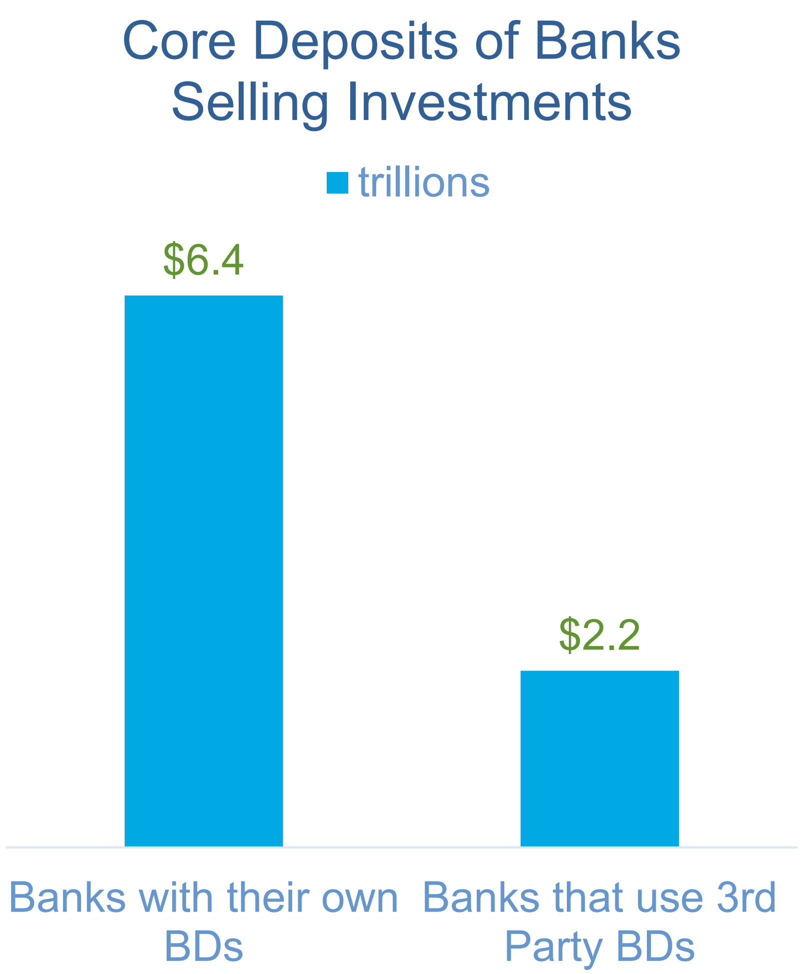
The banks in the retail investment services business have $8.6 trillion in core deposits, almost 80% of the total for all chartered banks in the US.

Bank-owned BDs are concentrated in the larger banks, which hold 74% of the core deposits in banks offering investment services.

Cost and regulatory pressures are driving banks with their own BDs to consider outsourcing. During the past year, one bank outsourced the BD function, while another exited the business.

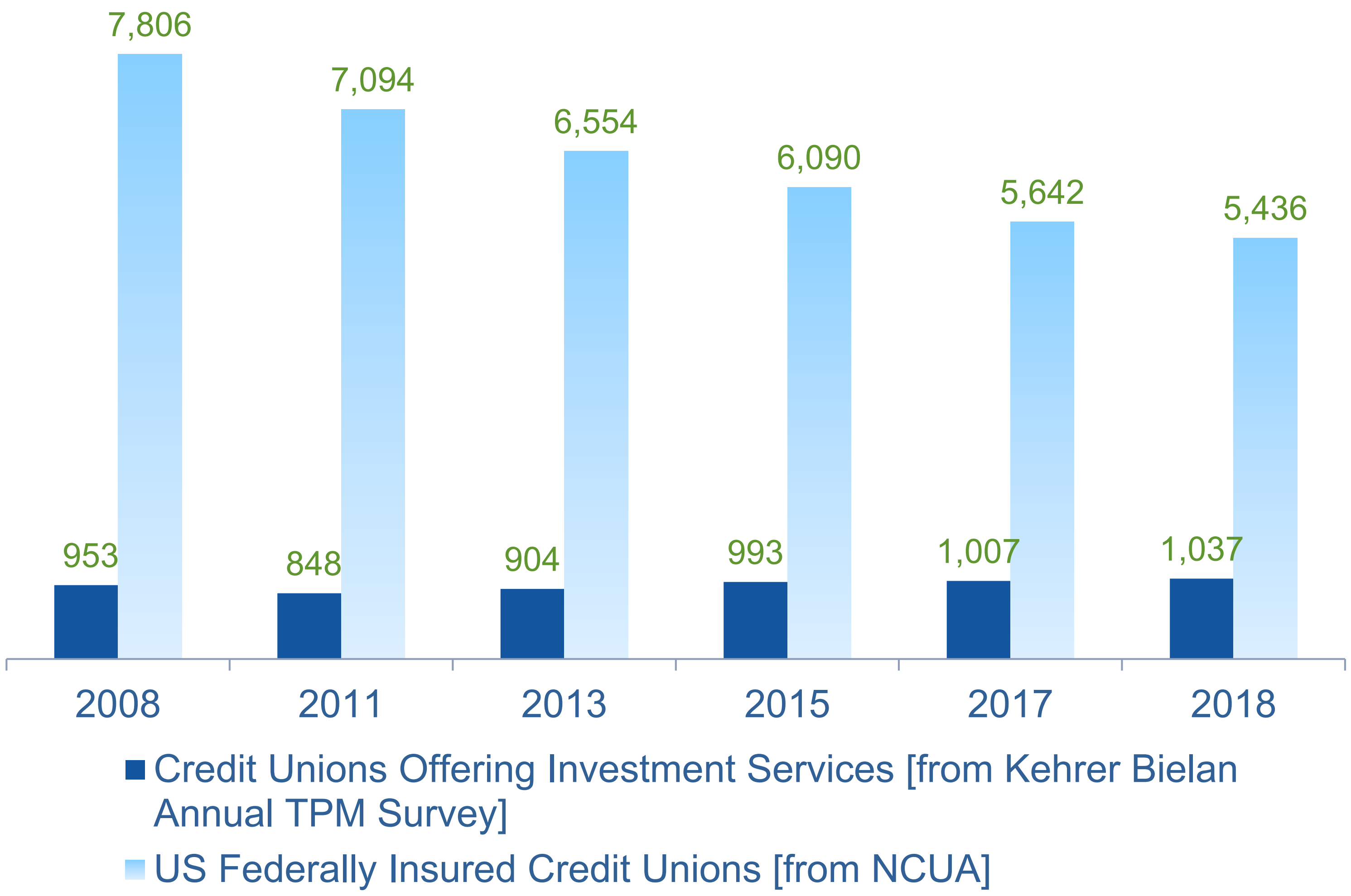
A few other retail banks sell investments through a bank affiliated BD but outsource much of the processing to a third-party BD.

Source: FDIC and proprietary research



Trends in Number of *Credit Unions* Offering Investment Services

The number of credit unions selling investments increased 3%, but the number of credit unions continues to consolidate.



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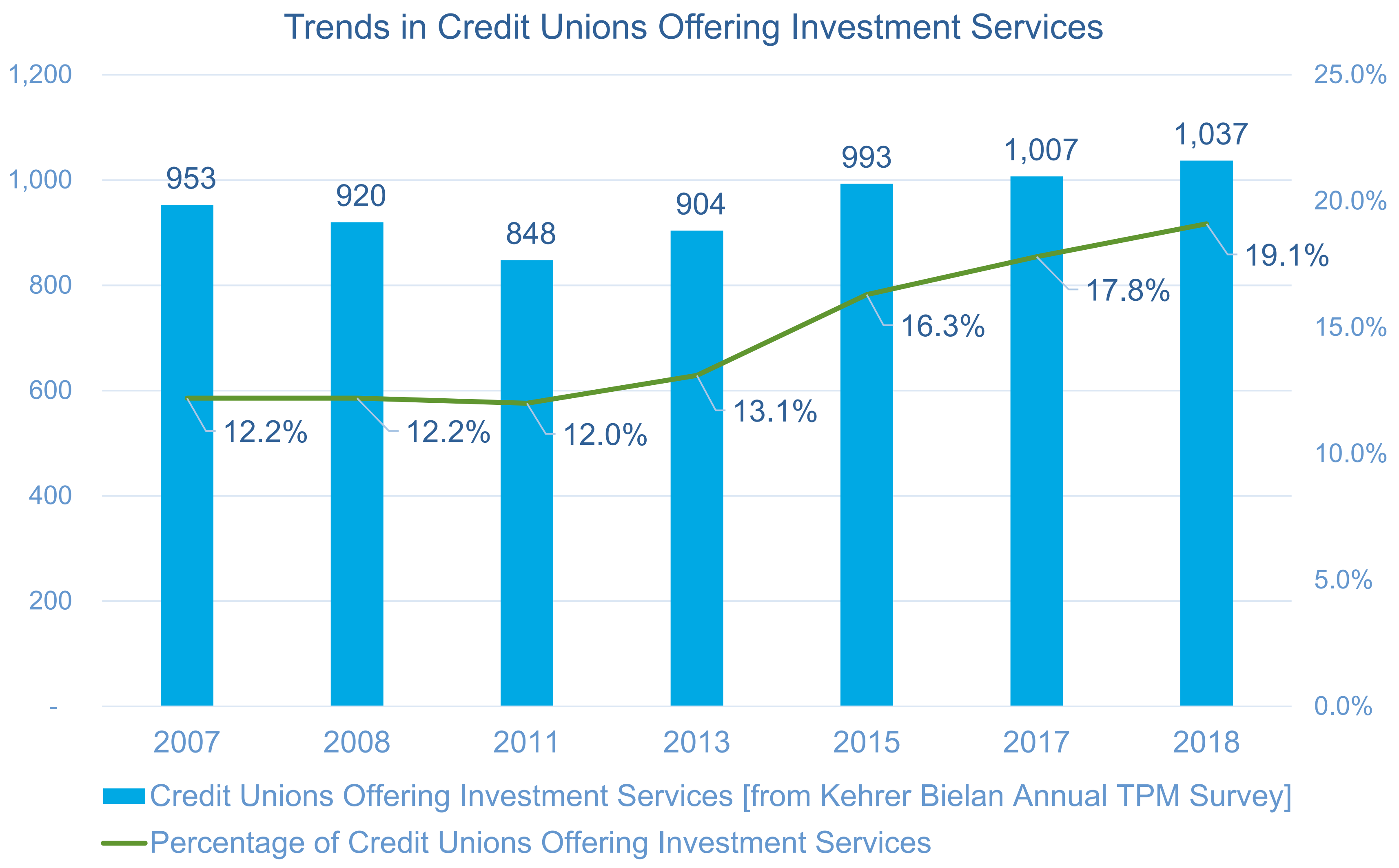
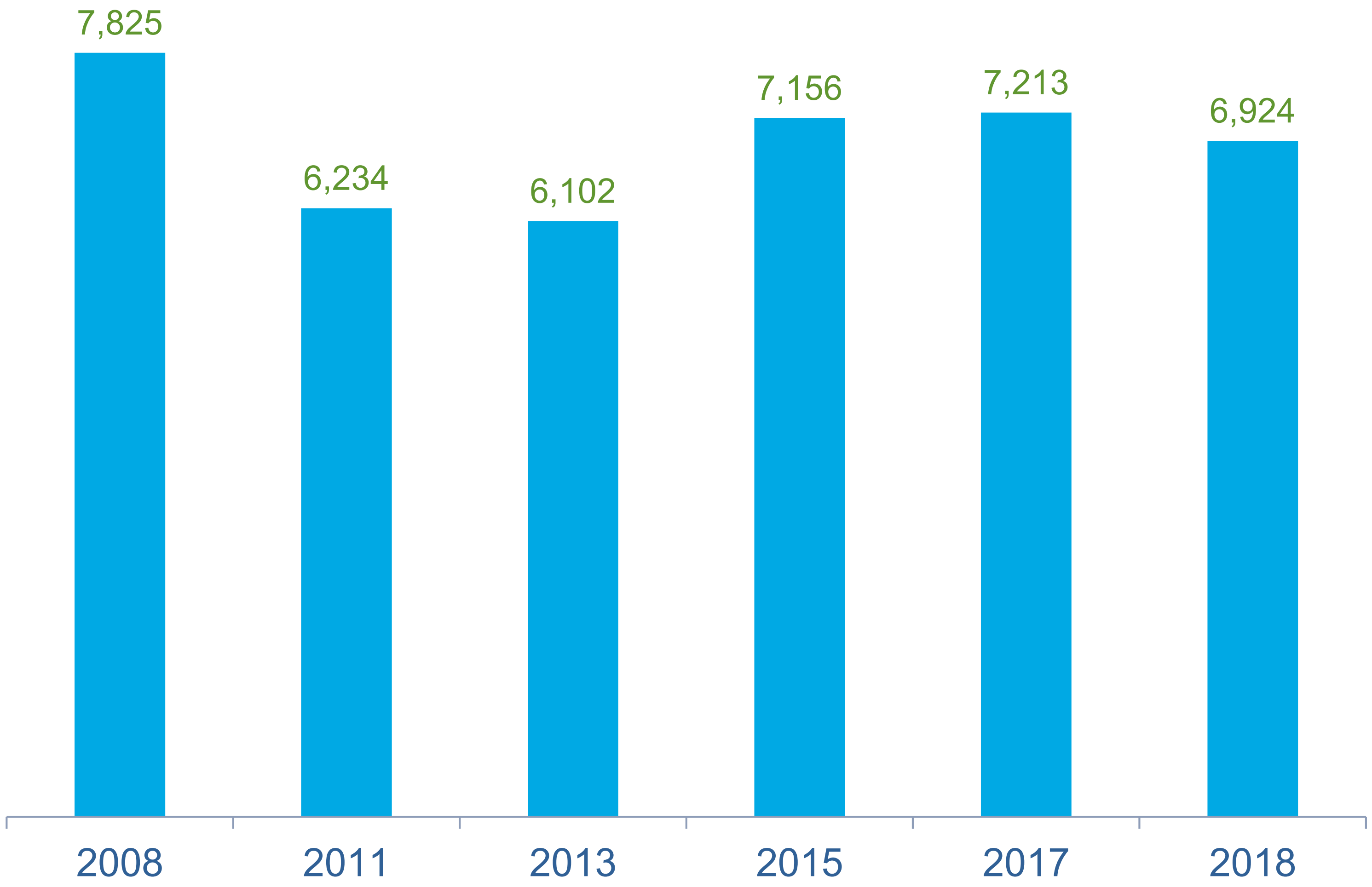
Trends in Share of *Credit Unions* Offering Investment Services through TPMs

Consequently, the share of credit unions selling investments has been growing steadily.



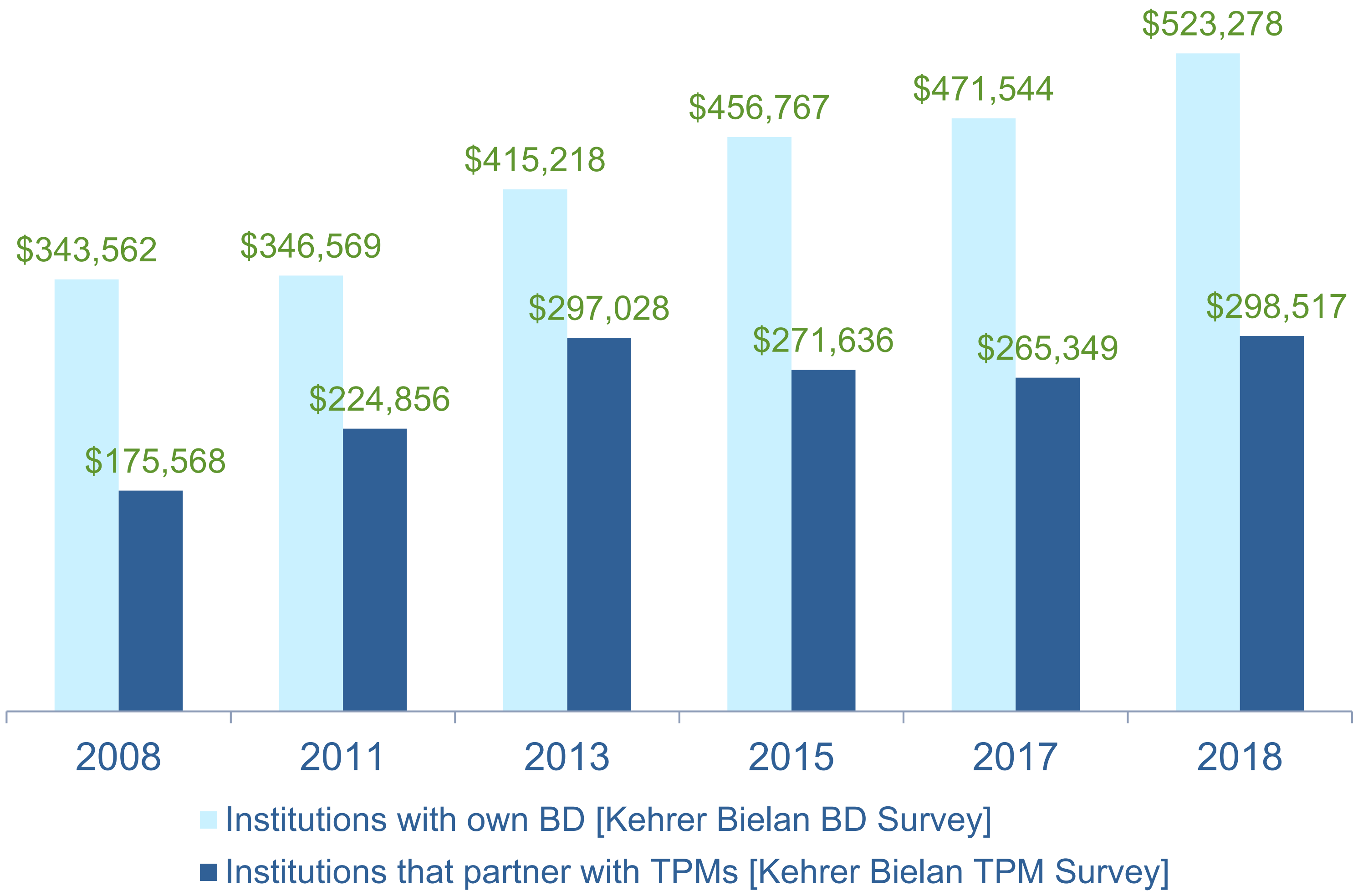
Trends in Financial Advisor Headcount in TPMs

The number of financial advisors affiliated with third party broker-dealers declined 4.0%.



Trends in Financial Advisor Productivity in Banks and Credit Unions

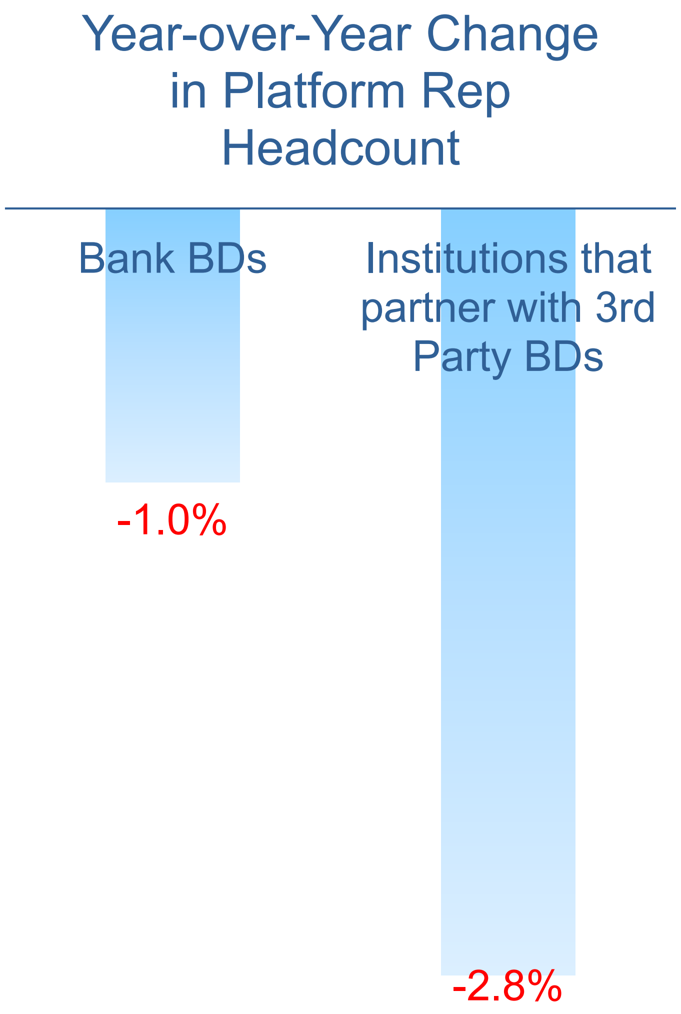
Average gross revenue per advisor increased 11.3% in Bank BDs and 12.5% in banks and credit unions that partner with TPMs. Advisors in the largest banks have much higher productivity.



Trends in Platform Reps

Licensed banker headcount shrank year-over-year, but the number of LBs working in banks and credit unions that use third party BDs declined nearly three times as fast as in the Bank BDs.

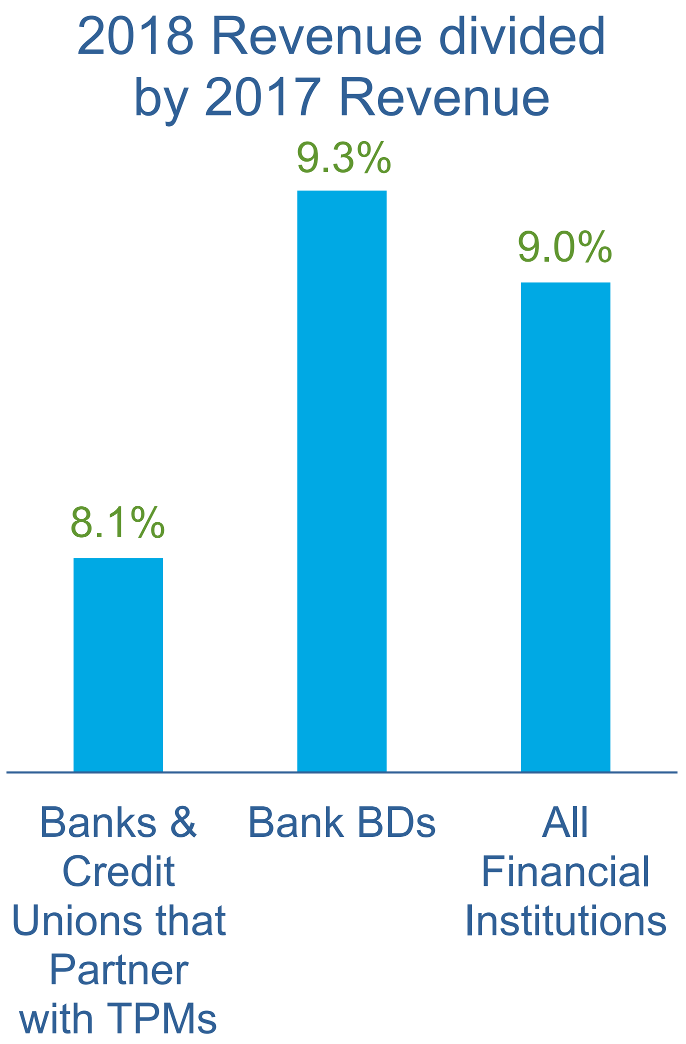
In recent years, many firms started restricting these “platform reps” to only referring, instead of personal sales.



Year-over-Year Growth in Investment Services Revenue

Investment services revenue increased 9% in banks and credit unions in 2018, driven primarily by the increase in market valuation of assets under administration during the year.

Revenue in Bank Broker Dealers grew faster than in institutions that work through third-party broker dealers, a reflection of the fact that the Bank BDs derive a greater share of their revenue from advisory business and benefited more from the hot market as a result.

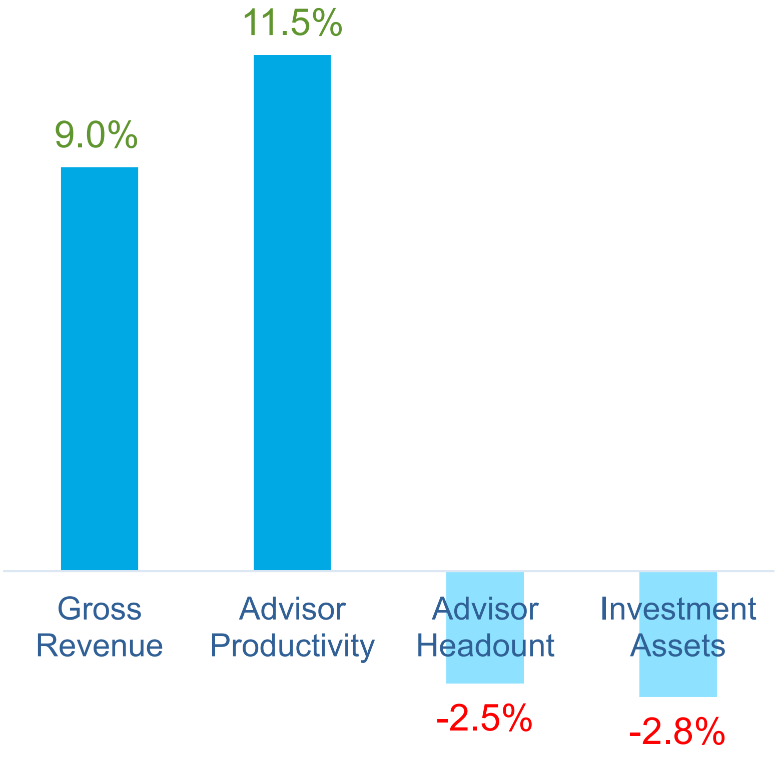


Year-over-Year Metrics for All Financial Institutions

Investment assets shrank slightly as the market correction in the fourth quarter eliminated all gains on the year, and effectively offset any new asset acquisition that occurred during the year.

Nonetheless, gross investment services revenue increased significantly, while average revenue per advisor received an additional boost from a decline in advisor headcount.

Trends in Investment Services: All Financial Institutions



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Year-over-Year Metrics for Bank Broker Dealers

The increase in Bank BD revenue was fueled by the increase in market valuation of assets under administration during the year.

Advisor headcount slipped slightly for the second year in a row, but that meant that average production for the remaining advisors was up a robust 11.3%.

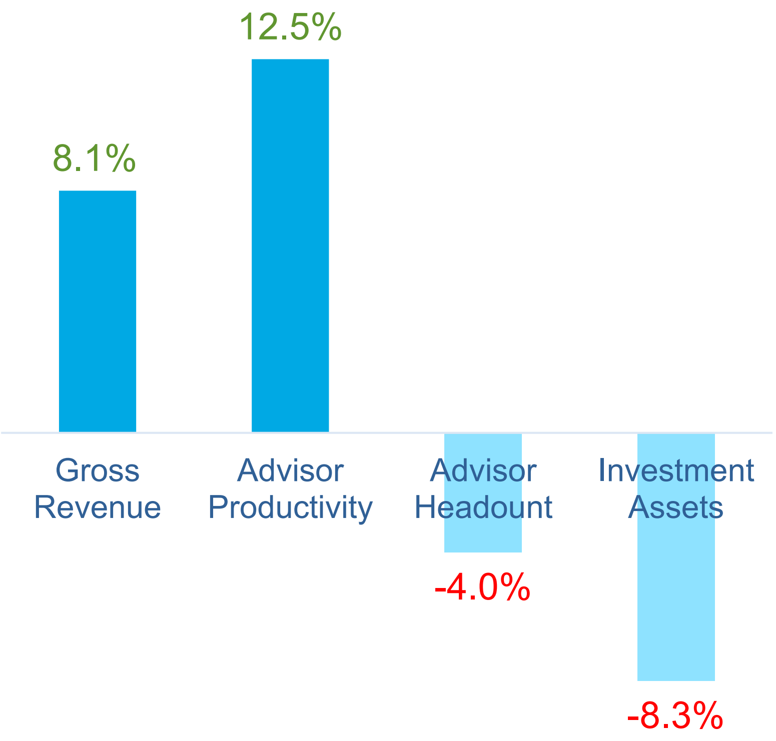
Assets under administration at the end of the year were down slightly after the market correction.

Year-over-Year Metrics for Financial Institutions that Partner with TPMs

Growth in gross revenue in banks and credit unions that work with third party BDs lagged Bank BDs, as headcount shrank twice as much in those institutions.

Investment assets in the TPMs declined much more sharply than in the Bank BDs, which had the advantage of several quarters of growth on relatively more AUA, before the market correction.

Trends in Investment Services: Banks & Credit Unions That Partner with 3rd Party BDs



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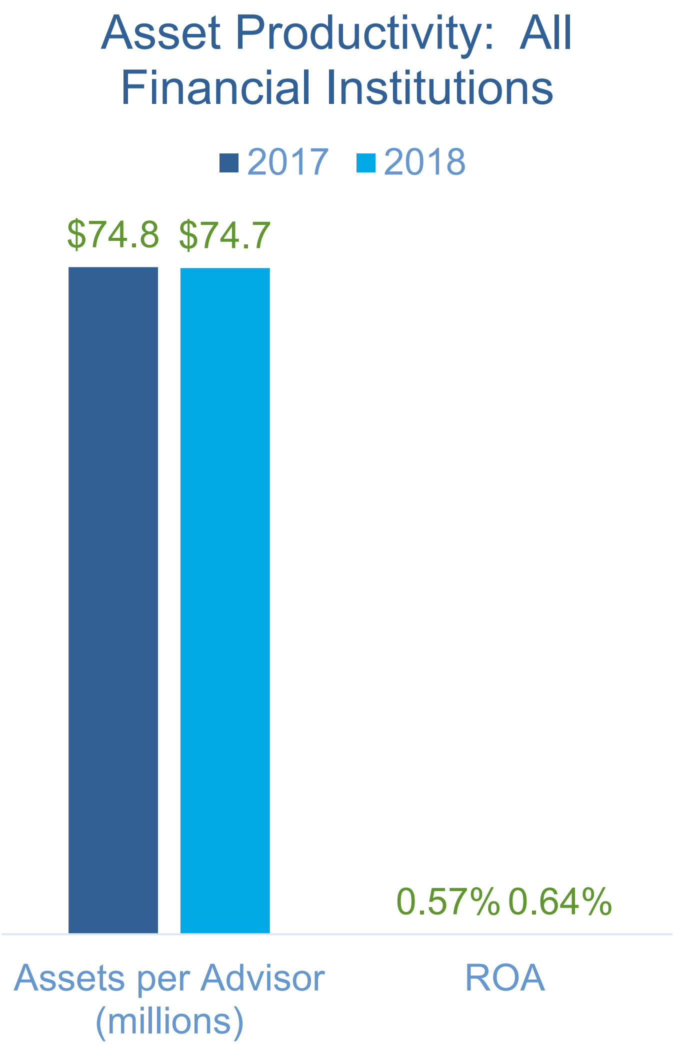
Year-over-Year Metrics for All Financial Institutions: Asset Productivity

The typical advisor based in a financial institution managed $74.7 million in client assets at the end of 2018, essentially unchanged from the previous year.

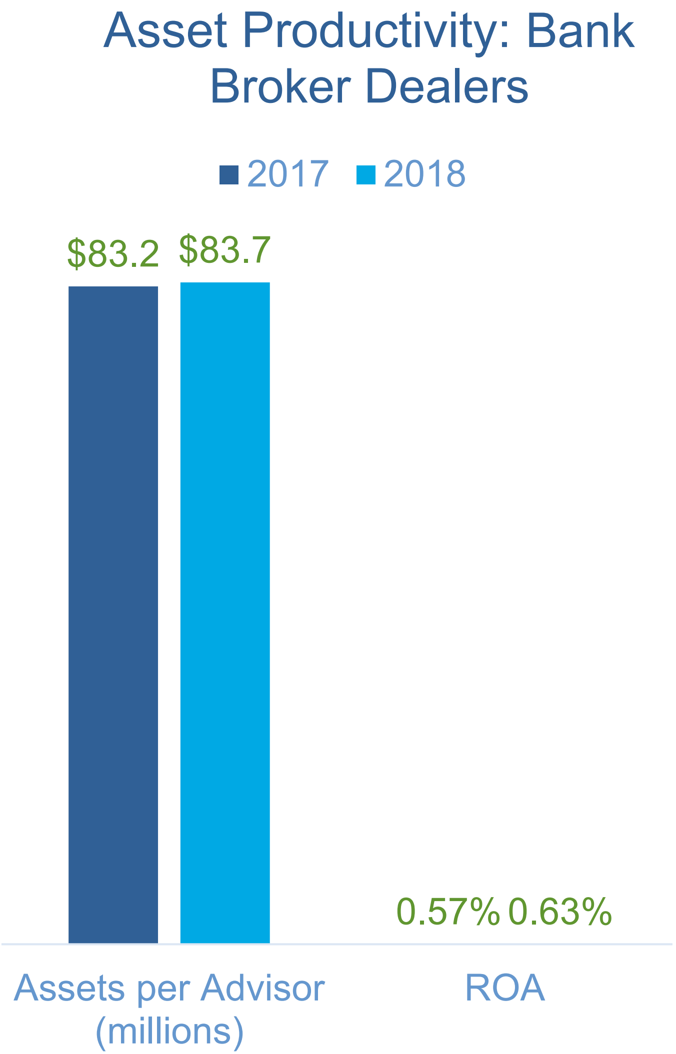
But the ROA on those assets improved by 7 basis points, as the market correction's impact on revenue did not hit in 2018, resulting in an increase in revenue for the year while assets declined by year end.



Year-over-Year Metrics for Bank Broker Dealers: Asset Productivity

Despite the market correction, the average book of business in the Bank BDs grew slightly on the year, as firms shed headcount.

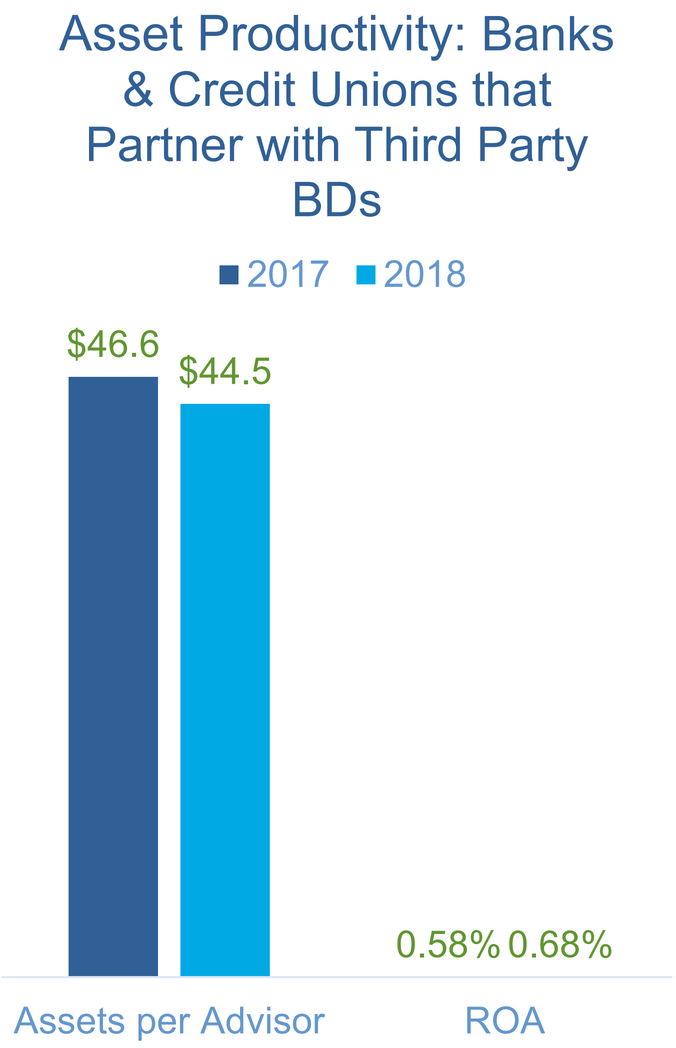
ROA in the Bank BDs improved by 6 basis points, as revenue grew faster than assets.



Year-over-Year Metrics for Financial Institutions that Partner with TPMs: Asset Productivity

The typical advisor affiliated with a third-party broker dealer saw their book shrink by $2.1 million in 2018.

But the ROA on those assets improved by a whopping 10 basis points thanks to the timing of the market correction and the lag in advisory fees.



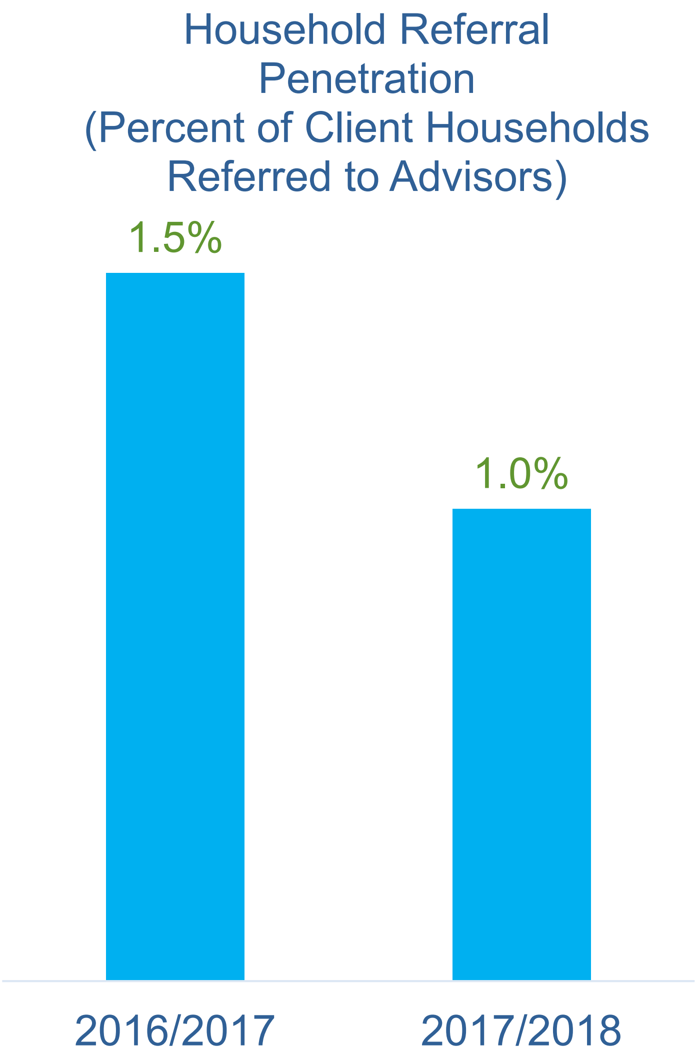
Household Referral Penetration

The share of institution customer households referred to advisors was down one-third year over year.

Declining branch traffic and the acceleration of branch closings is stressing the traditional branch referral model.

- FDIC reported 1,700 branch closings in the 12 months ending in June

A decade ago, financial institutions referred over 2% of their customers every year.



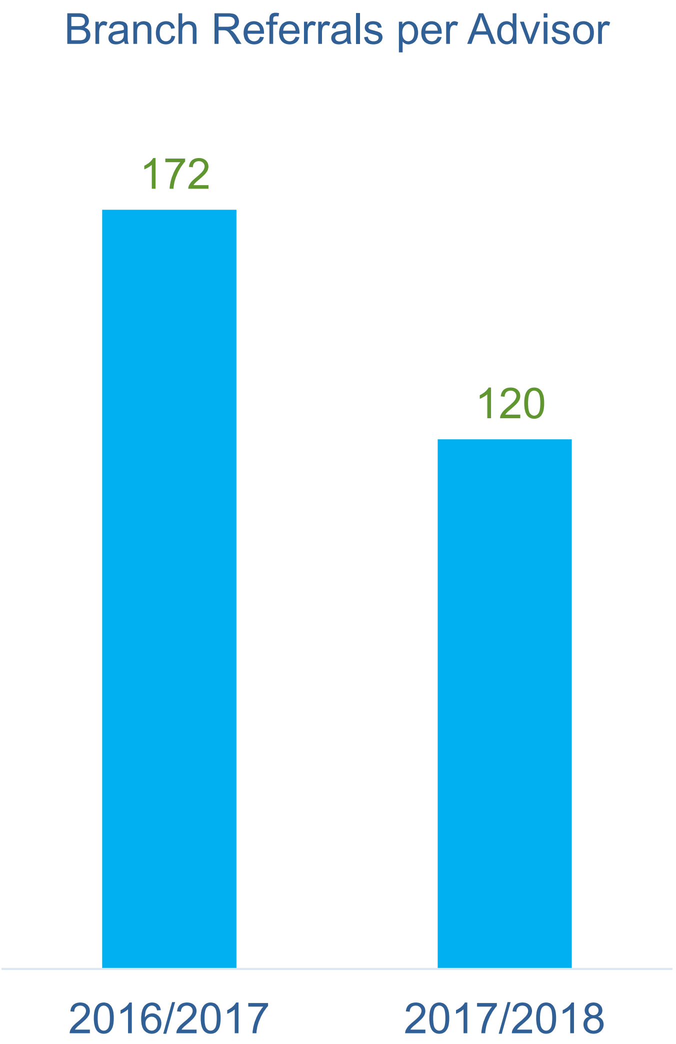
Referrals per Advisor

Advisors are now receiving only 10 branch referrals a month, on average

- Down 30% from the previous year

Because of the promise of referrals, banks and credit unions had been able to provide payouts that are 7 percentage points lower than standalone advisors earn at every production level.

Firms need both to reenergize the referral stream and develop other ways to drive business.



Looking Ahead to 2019

The race to the bottom of fees for low-cost, autopilot investment management vehicles will continue to intensify **revenue compression**, particularly on firms that have built a business strategy on accumulating advisory assets.

Firms will face increased **technology expenses** to compete for investors and advisors and provide more efficient ways to deliver financial advice to segments with questionable profitability.

Financial institutions will accelerate their efforts to **segment delivery** of investment and wealth management services, seeking to better match clients served by across-the-desk advisors, licensed or registered banking staff, investment call centers, digital advice platforms, self-directed tools, and wealth advisors.

Looking Ahead to 2019 (cont.)

We see lots of talk about the importance of **financial planning,** but making it a core role performed by advisors and firms has yet to take hold. This is a serious concern as firms fall behind other competing financial channels.

Referrals will continue to decline, making it necessary to identify higher value referrals, increase the conversion rate and find alternative referral channels.

Disappointing penetration of wealthy clients is finally pushing some institutions to assess the traditional delivery of **wealth management services** in silos, as they examine melding product offerings, integrating sales forces, unifying back offices, and improving the advisor and client experience.

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Looking Ahead to 2019 (cont.)

Recruiting has increased in difficulty and firms are either doubling down on up front compensation or finding advisors by deploying associate advisors, graduating licensed bankers, anointing second story advisors, or creating training programs to grow their own. But we see some firms capitulating to the talent scarcity and accepting the stagnation of the biggest potential driver of incremental revenue—additional advisors.

Advisor's compensation grids rise steeply until annual production of $500,000, then level out, making $500,000 the perceived target production for a financial institution advisor. Compensation plans still overweight production and pay little for behavioral performance, even though firms view those behaviors as very important.

Looking Ahead to 2019 (cont.)

As traditional banking products become harder to **differentiate** and digital entrants take market share, one of the few remaining and best value additions to a branch for clients is the **advice an advisor provides**. In spite of that, many firms are under pressure and limited investments are being made. This continues a long-term trend with negative long-term results.

All these factors will lead some firms to consider abandoning business as usual and **contemplate dramatic changes** to their business model; however, the **actual pace and magnitude of change are minuscule.**

Insights Based on Kehrer Bielan's 2018 Research

Second Story Advisors

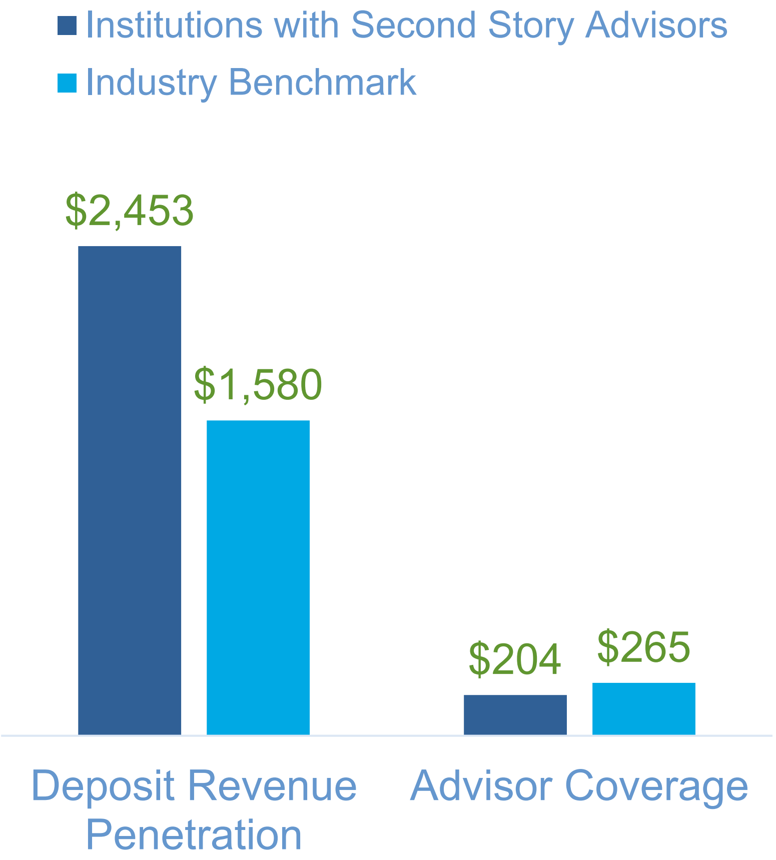
Source: *Moving UP: Working on the Second Story without Branch Referrals* (LPL Financial Institutions)

Second Story Advisors do not receive referrals from the branches

- Many have "graduated" from the branches as their practice has grown
- Others have been recruited into the role, or are embedded in other areas of the bank

Firms with Second Story advisors have 55% better revenue penetration of deposits, largely because they have 30% thicker advisor coverage of the deposit base.

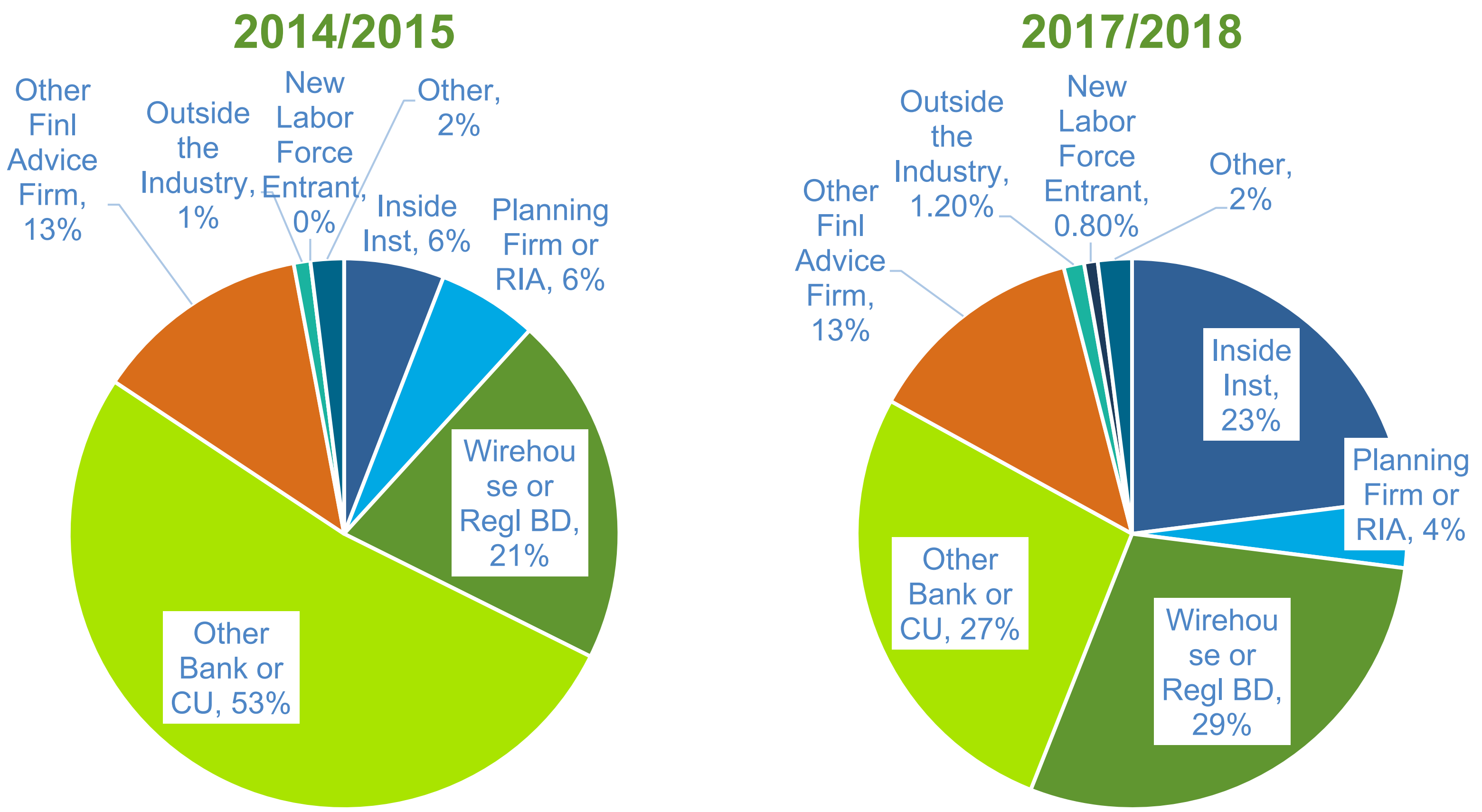
Revenue Penetration and Advisor Coverage
(per million in consumer deposits)



Growing Your Own

In the past 3 years there has been a marked shift away from recruiting from other banks toward sourcing candidates internally

Source: *Where Will the Next Generation of Advisors Come From?* (Cetera Financial Institutions)



Identifying Households with Hidden Assets

Source: *Improving Client Segmentation: Increasing Wallet Share by Identifying Hidden Assets* (LPL Financial Institutions)

Investment services firms in financial institutions are focusing more on segmenting their clients

- Focusing advisors on more profitable clients and serving others through investment call centers or digital platforms
- Reaching out to customers proactively as branch traffic has plummeted and referrals have withered

Consequently, there is increased interest in ascertaining which low balance customers have substantial assets held outside the institution.

This research mined consumer data from the *MacroMonitor*, the gold standard of surveys of consumer financial behavior, to demonstrate that the accounts that a household has at the institution can substantially increase the likelihood of identifying

- Who has significant assets held at other firms,
- What their channel preferences are; and
- How to engage with them.

About CUSO Financial Services and Sorrento Pacific Financial

CUSO Financial Services, L.P. and Sorrento Pacific Financial, LLC (Members FINRA/SIPC) are subsidiaries of Atria Wealth Solutions. Established in 1997, they specialize in placing investment programs inside credit unions and banks, providing customized investment and insurance solutions to over 200 financial institutions throughout the country, with $30+ billion in AUA. Headquartered in San Diego, with branch offices nationwide, both broker-dealers are SEC Registered Investment Advisers, with expertise in key areas including retirement services, wealth management, advisory solutions and insurance products for individuals and business customers. For more information, see www.cusonet.com or visit their LinkedIn pages: CFS and SPF.

About Kehrer Bielan

Kehrer Bielan Research & Consulting provides the financial advice industry with insights based on a melding of research and experience in managing the delivery of investment, insurance, and wealth management services.

The firm's principals—Kenneth Kehrer and Peter Bielan—have participated in the financial advice industry as executives, researchers, analysts, and spokespersons for over 30 years. Together they bring a unique, unbiased resource and perspective through their original research, actionable advice, and keen understanding of where the industry has been and where it needs to go.

Meet the rest of the Kehrer Bielan team, check out our research library and study groups, and scan our client list and consulting engagements at http://kehrerbielan.com.