



Student
International
Business Council



Fall 2015 Ernst & Young Consulting Project
November 20th, 2015



**Should State Farm
grow, sell or maintain
the size of their bank
services?**

AGENDA 11/20



1. Team Presentation

2. Research Information

A) External Factors

Industry Financials

Trends & Growth

External Environment

B) Internal Factors

State Farm Insurance & Bank

Revenue and Cost

3. Analysis & Conclusions

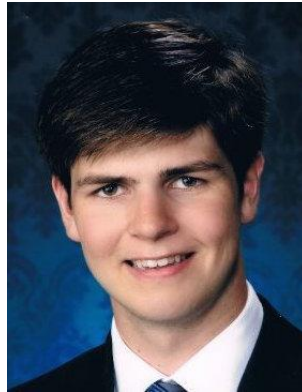
Our Team



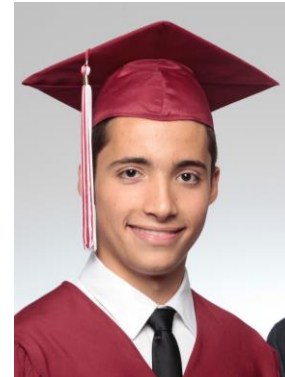
Timothy McCabe
Finance & Economics
2018
Flanders, NJ



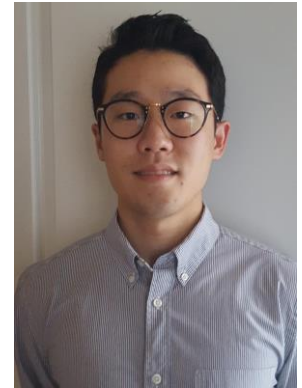
Carl Schiro
Finance & Political Science
2018
Austin, TX



Matthew Laboe
Chemical Engineering
2018
Naperville, IL



Jean Paul Laffitte
Economics
2019
Panama City, Panama



Young Jae Woo
Management & Spanish
2017
Seoul, South Korea



Jorge Nazario
Computer Science &
Engineering
2019
Guaynabo, Puerto Rico



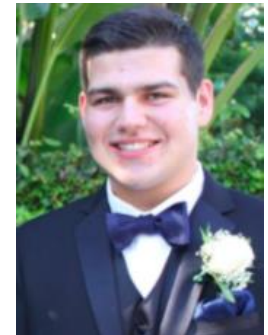
Shao-Ming Yang
Science-Business
2017
Oakland, CA



Astrid Brakstad
Economics & Applied
Mathematics
2019
Oslo, Norway



Dong Wook Ko
Accounting
2018
Seoul, South Korea



Luc Maynor
Business Undecided
2018
Glendora, CA

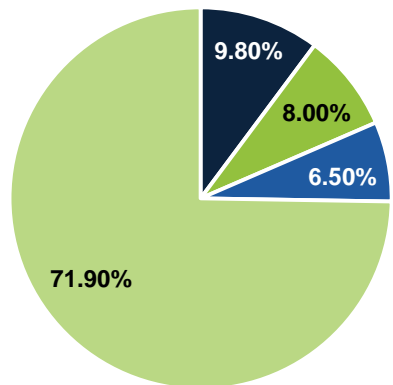


2A) External Factors – **Industry Financials**

Introduction to Market Environment



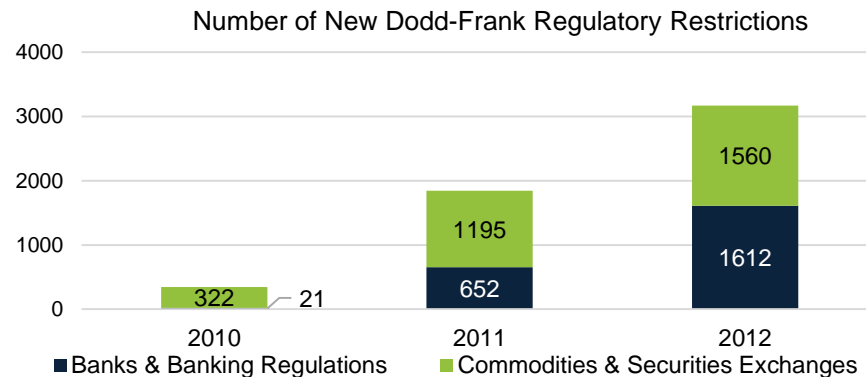
Market Share & Major Companies



- Wells Fargo & Company
- JPMorgan Chase & Co.
- Bank of America Corporation
- Other

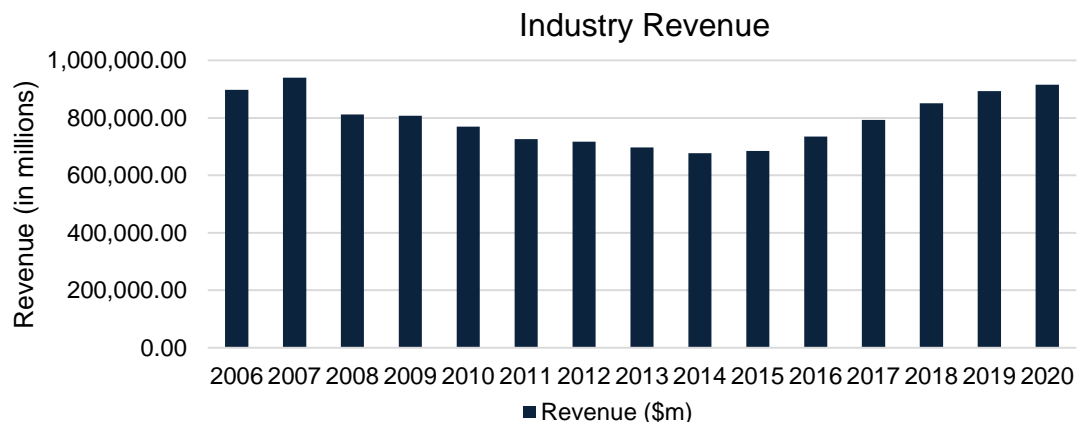
- **Concentration: low**
- Supreme Mortgage Crisis caused **large-scale merger and acquisition**
- Many **unprofitable banks exiting** the market
- As the **credit market thaws** and **interest rates recover** from recessionary lows, **bank lending is anticipated to rise.**

Increasing Regulatory Costs



- **Regulation: Heavy & increasing**
- Banks invested significantly in compliance.
- **Larger banks** - with assets over \$50bil - **are expected to grow faster than smaller banks.**

Improving Industry Performance



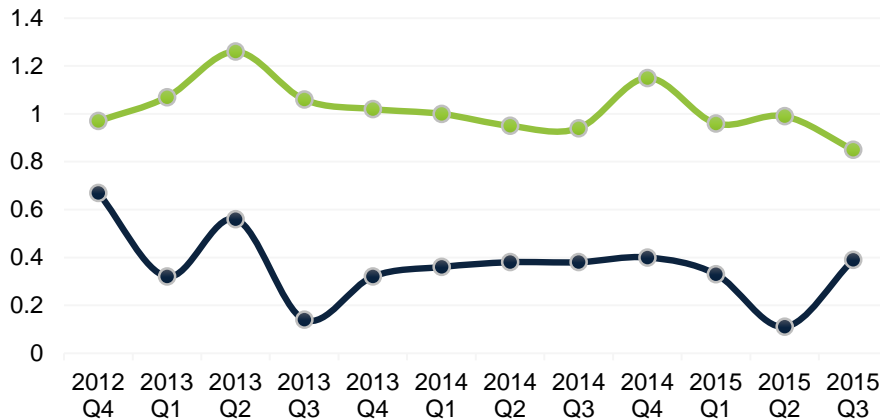
- The **number of banks decreased** yet **revenue remains mostly the same.**
- Large banks are taking over
- Recession made a **bank's reputation more important.**
- Consumers **trust** these **bigger** more **reputable banks** and as a result are leaving smaller, less well known banks
- **Revenue** is expected to **increase** at an annualized **rate of 6.0% over the next five years.**

Industry Financial Ratios

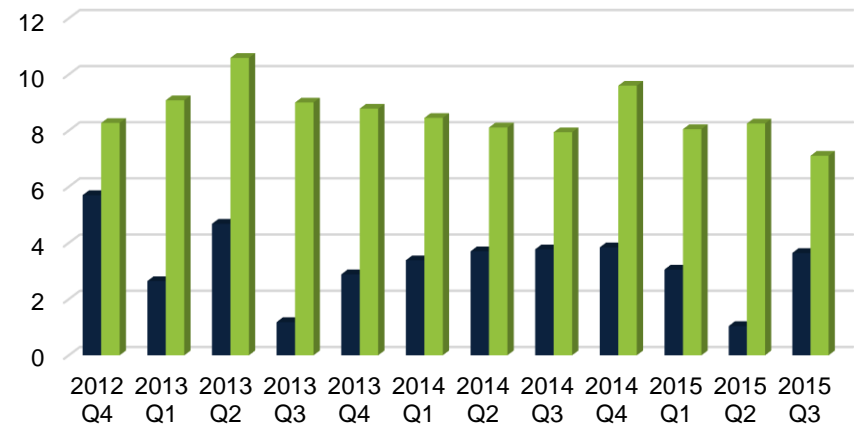


State Farm Bank and Peer Profitability Ratios

ROA Ratios of SFB vs Peers

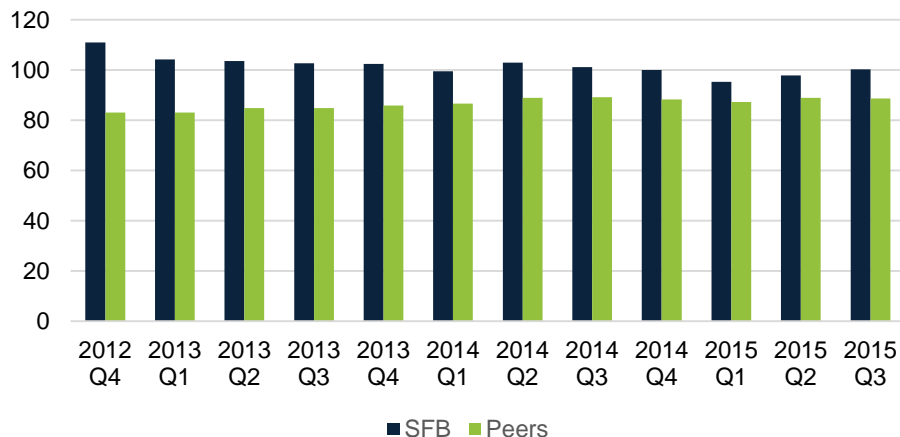


ROE Ratios of SFB vs Peers

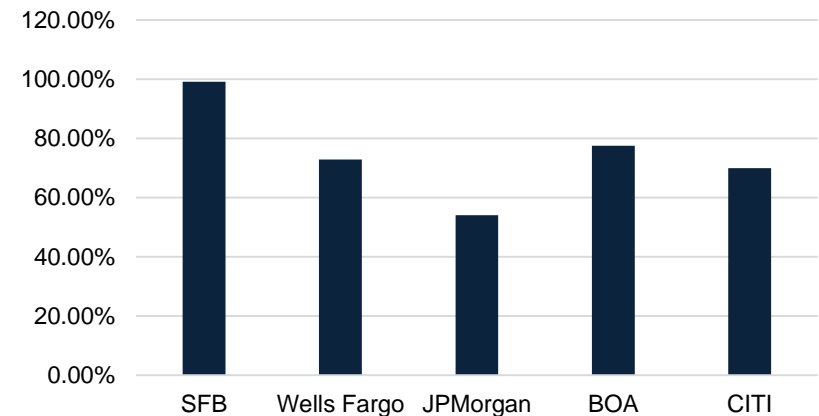


State Farm Bank and Peer Loan to Deposit Ratios

LTD Ratios vs Peers



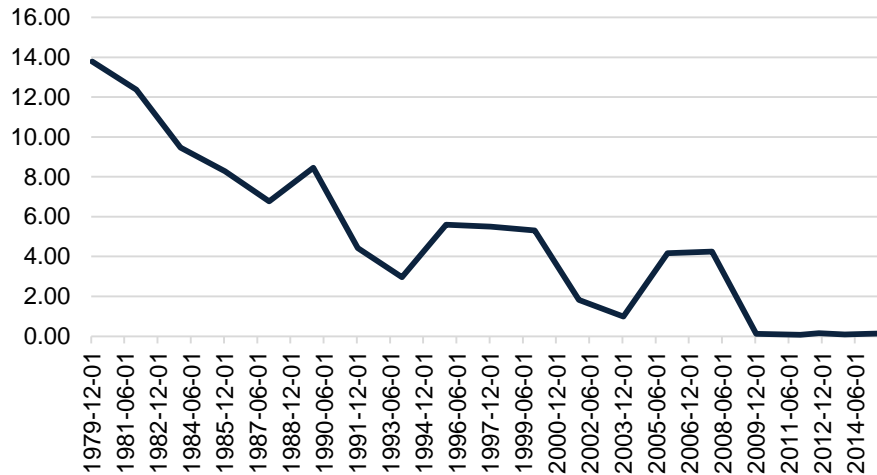
LTD Ratios for 2015



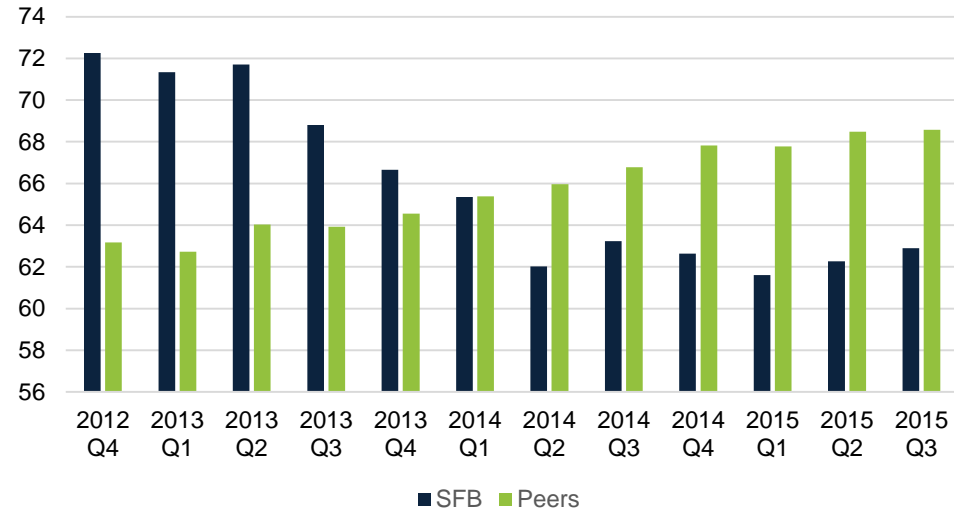
Industry Financial Ratios



Federal Funds Rates since 1979



Loans-to-Assets



- Federal Funds rate is effectively zero
- While this helped banks in the short run, most are anxious for rates to return to higher levels as profits are tied to short-term floating rates
- While interest rates will increase overnight, deposit rates will lag, creating a short term window of profitability.
- State Farm may want to wait until the Fed raises rates to reassess its profitability and position in the market.

- State Farm's Loans-to-Assets ratio has been decreasing for the last 3 years, while peer banks' ratio has been increasing
- This could mean that SFB is diversifying their services from just loans

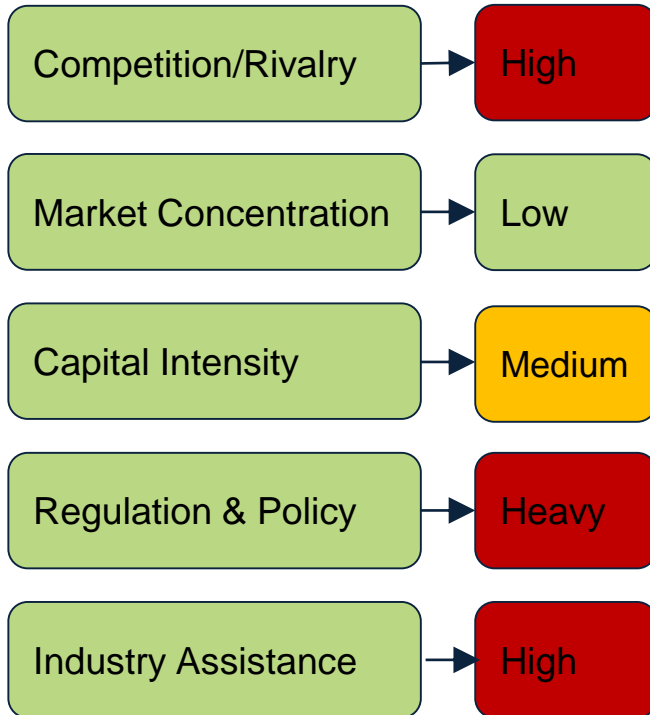


2A) External Factors- **Trends & Growth**

Industry-Trend and Growth

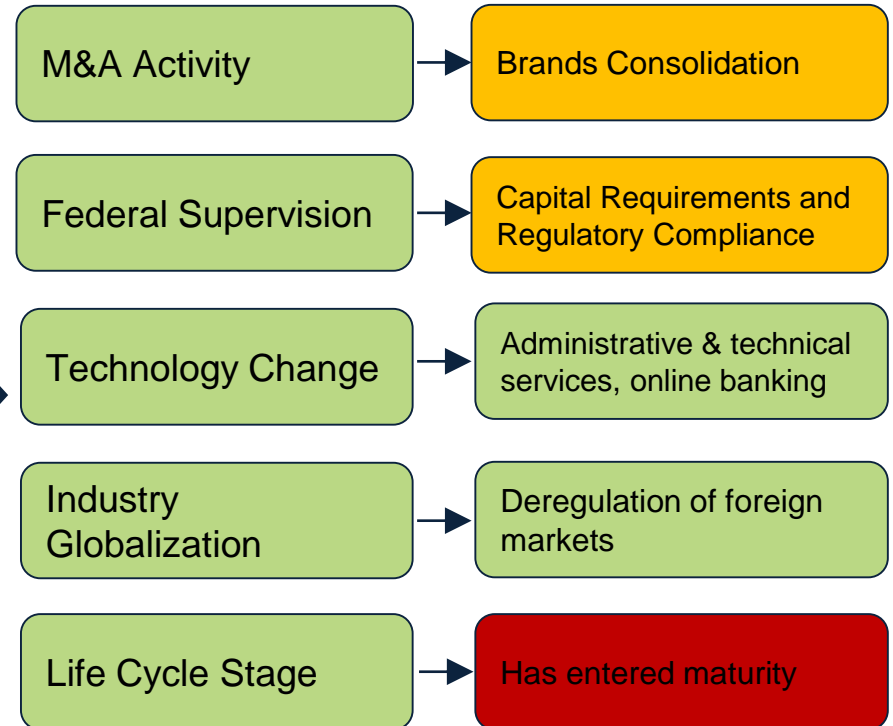


Barriers to Entry



- Supervision and regular inspections by federal and state regulatory agencies.
- Industry competition from large firms deters new firms from entering.

Barriers to Continued Growth



- Nontraditional competitors utilizing mobile platforms and online banking will appeal to Gen Y customers
- Increased competition & lower distribution costs pressure the industry profitability, causing the industry to consolidate further.

Industry Trend and Growth



Banking Industry Trends

Interactive Banking

Banks will become more personal with targeting and engaging consumers

Increasing Customer Rewards

As interest rates continue to go up, relationship rewards are expected to rise as well

Mobile Payments

Mobile payments expected to grow by 61% in 2015

Trends in Competitor's Strategies

Vanguard:

Client has more ownership, focuses on the individual

Wells Fargo:

Emphasis on connecting with stakeholders and lowering risk

Fidelity:

Diversify investment categories

Nationwide:

focus on promoting as one brand to strengthen distribution & enhance service

Allstate:

Prioritize the customer and community

Current consumer trends in the industry are important factors in competitor's strategies

Industry-Trend and Growth



Principal Financial Group	
<ul style="list-style-type: none"> • High credit rating • Easier access to capital resources • Sign of high asset quality and strong financial performance • Increase in revenue in 2014 • Broad product and service portfolio 	<ul style="list-style-type: none"> • Decline in cash position • Fee based business model • If clients migrate to lower yielding products, this could affect their NAV and the bank's earnings
<ul style="list-style-type: none"> • New offerings • Extension of retirement savings and real estate funds gives competitive advantage • Recovering US economy • New opportunities in Hong Kong 	<ul style="list-style-type: none"> • Fluctuations in interest rates • High competition in the industry • Changing regulations may result in additional cost • FDIC Insured

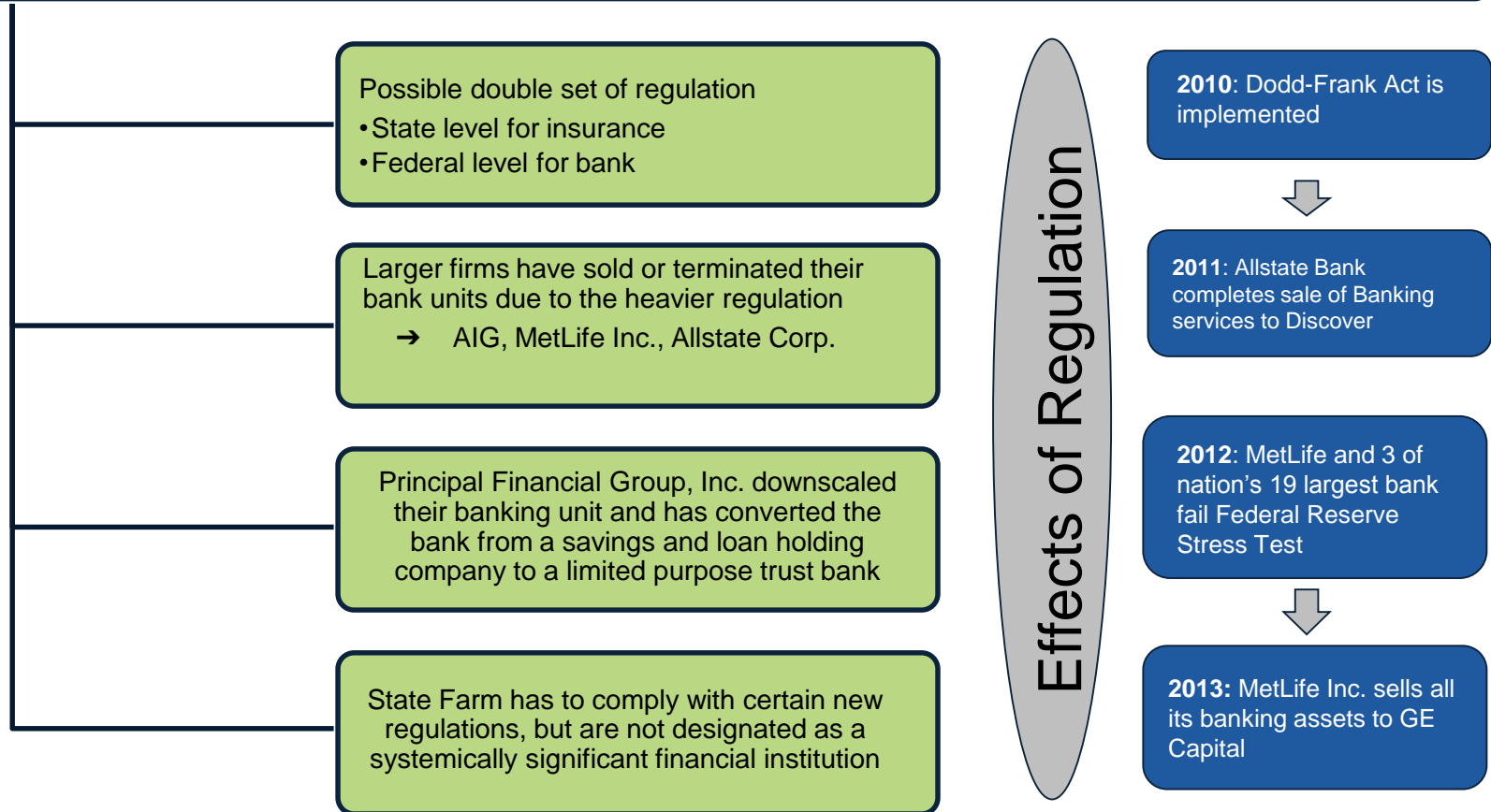
Principal Financial Group continues to demonstrate growth in net income as well as revenue, and has shown an increase in banking operation deposits in 2014

USAA	
<ul style="list-style-type: none"> • Offers a variety of services • Flexible mobile and online services • High perception of company name • Low credit fees • Awarded customer service • Top-level management 	<ul style="list-style-type: none"> • Limited client base (only veterans, currently serving, and family members) • Limited diversified geographical presence • Not FDIC Insured
<ul style="list-style-type: none"> • Expand eligible client base • Open offices overseas to better serve their customers at other locations • High reputation • Could charge sales of mutual funds etc. 	<ul style="list-style-type: none"> • Not eligible customers will go to competitors by default • The industry is following in development of mobile banking applications

USAA with its awarded customer service and high reputation continues to grow both in members and in net worth. Over 30 percent of pre-tax revenue came from banking in 2014



Insurers with bank units



Larger institutions with a majority of their business in the insurance industry have tended to sell their banking units as to avoid another set of regulations, or convert their bank units to other classifications



2A) External Factors- **External Environment**

Major Regulations



Basel III

- Higher capital requirements
- Increases in banks' risk-weighted assets
- Decreases in ROE
- Asset management have less balance sheet impact.
- Banks with balance sheet-light practices can expect higher returns.

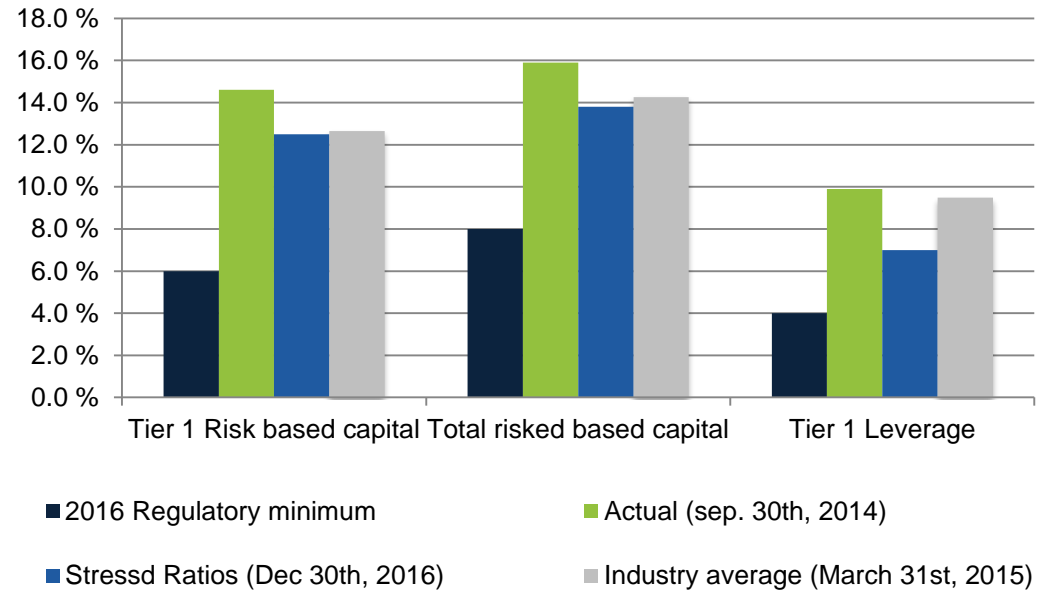
DFAST

- Maintain higher levels of capital
- Integrate stress testing into risk management and capital planning
- Bear the cost of cooperating with regulators.

Dodd-Frank

- Large banks are better equipped to handle greater regulatory burdens.
- Major consolidation
- Lending for banks becomes more difficult.

Capital Ratios from Stress Tests



Sufficient capital levels and financial position

Able to absorb losses with adequate reserves

Strong liquidity over stress test horizon

State Farm shows robust ratios well above the requirements and the industry average. State Farm would survive under these regulations; however, falling under this supervision is not ideal.

Regulatory Consequences



Cease Banking Operations

- No regulatory costs
- Many cons:
 - Loss of revenue
 - Loss of potential avenue of new customers
 - Cost of closing bank

Maintain Current Size

- Can adequately handle current regulations
- No risk of incurring more regulations due to growth
- Regulations expected to become more invasive and eventually will apply

Expand Bank

- Larger in size: more equipped to deal with regulatory burden
- Possible designation as Significant Financial Institution: more restrictions

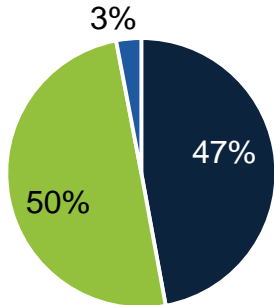
The benefits of expanding State Farm Bank are outweighed by the potential increase in regulatory burden. Many of these benefits can still be achieved by maintaining the current size of the bank.

Current Client Base



Commercial Banking Industry

Major Market Segmentation (2015)



Total: 684.4 billion

- Corporate Clients
- Retail Customers
- Other Clients

Retail Customers

- Deal in small transaction sizes
- Sheer proportion makes this segment significant
- Down slightly over the past five years due to frozen mortgage markets.

Corporate Clients

- Deal in a much larger scale of transaction value.
- Require large forms of business lending and deposit.
- Generally, larger corporations and institutional clients deal with commercial banks whose assets are greater than \$1.0 billion.

State Farm and State Farm Bank

State Farm Clients



- Not looking for new clients
- Working with existing State Farm households
- Not enough products and services to fill out the needs of high net worth clients

State Farm Bank Clients



- Middle income market focus
- Long-term relationships exist
- Many times long term relationships predate them being a high net worth household

Future Client Base – Trends & Projections



Commercial Banking Industry

Retail Customers

- Account-keeping fees and investments make these customers highly profitable.
- The ability to attract and retain these customers is essential.
- Market various other products and services to customers at minimal cost.

Corporate Clients

- Commercial banks with assets in excess of \$1.0 billion had a greater exposure to commercial, industrial and credit card loans.
- Commercial banking institutions with less than \$1.0 billion in assets had a greater exposure to residential mortgages, commercial real estate and agriculture loans.



State Farm and State Farm Bank

Current customers want a broader range of products and services



First and foremost with maintaining our focus on the middle market



Expanding our products and services to further serve the needs of our high net worth customers





2B) Internal Factors – **State Farm Insurance and Bank**

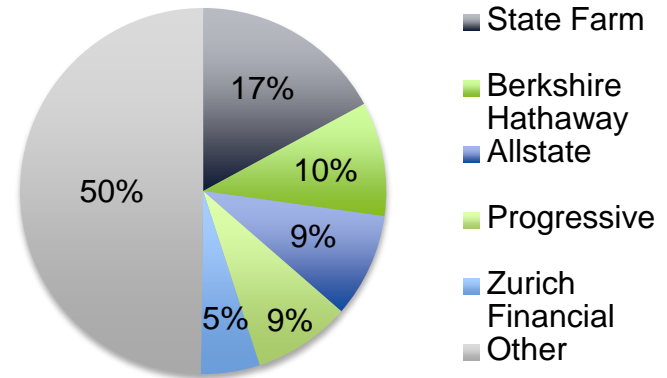
Major Player in Automobile Insurance



Company Info

- Headquartered in Bloomington, Illinois
- Founded in 1922
- Over 300 claim offices and employs 68,000 workers
- State Farm Mutual Automobile Insurance Company is the parent company of several State Farm subsidiaries

Market Share



Despite external factors such as financial crisis and natural disasters, in the past 15 years, State Farm Insurance maintained its winning position in the auto insurance market and continued to innovate and grow.

1990s

1998 - 1999

Launched State Farm Financial Services F.S.B; Started out with mortgage, home equity, and auto loans with no branch offices

1999

Held responsible for using poor quality replacement auto parts by Illinois state court

2000s

2001

- Exited New Jersey's auto insurance market
- Stopped accepting homeowners insurance in Texas due to mold plague

2005

- More than \$8 billion lose due to Hurricane Katrina

2008

- Financial Crisis
- Suffered more losses from storms in Atlanta and Midwest

2010s

2009 - 2010

- Launched applications
- No catastrophic disaster
- Earned \$777 million

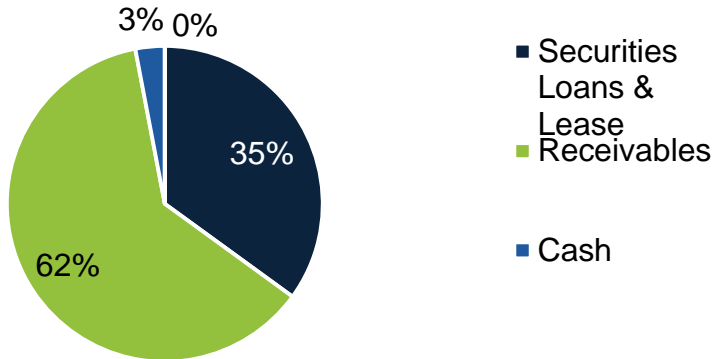
2011

- Recovering from 2008 financial crisis
- Targeting younger potential customers through advertising online

Current Good Standing with Regulatory Bodies



State Farm Bank Asset Distribution



More than 60% of State Farm's assets tied up in loans and receivables, which makes State Farm Bank more susceptible to defaults as liquidity is low. Diversifying financial services could appeal to clientele demands as well as lower risks.

Capital Ratios Vs. Regulatory Minimums

- State Farm Bank, F.S.B. has strong capital ratios
- Severely adverse scenario accounts for unemployment, GDP, equity markets, CPI, and Real Estate
- Exceeds "well-capitalized" capital ratio thresholds
- Strong liquidity in stress-test timeframe

Dodd-Frank Regulation

- State Farm Bank, F.S.B. has financial position and capital ratios to survive OCC severely adverse scenario
- Severely adverse scenario accounts for unemployment, GDP, equity markets, CPI, and Real Estate
- Exceeds "well-capitalized" capital ratio thresholds
- Strong liquidity in stress-test timeframe

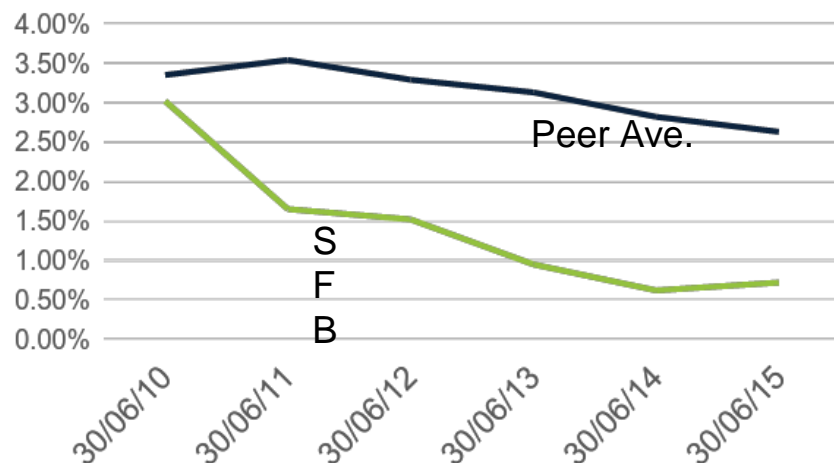
Tier 1 Risk-Based Capital	Total Risk-Based Capital	Tier 1 Leverage
Regulatory Minimum: 6.0%	Regulatory Minimum: 8.0%	Regulatory Minimum: 4.0%
Actual: 14.6%	Actual: 15.9%	Actual: 9.9%
Industry Average: 12.65%	Industry Average: 14.26%	Industry Average: 9.48%

State Farm Bank, F.S.B. is well positioned to comply with the Dodd-Frank Act regulations. The company-run stress test indicates that the bank could withstand a major economic crisis.

Investment in Client-centric Services



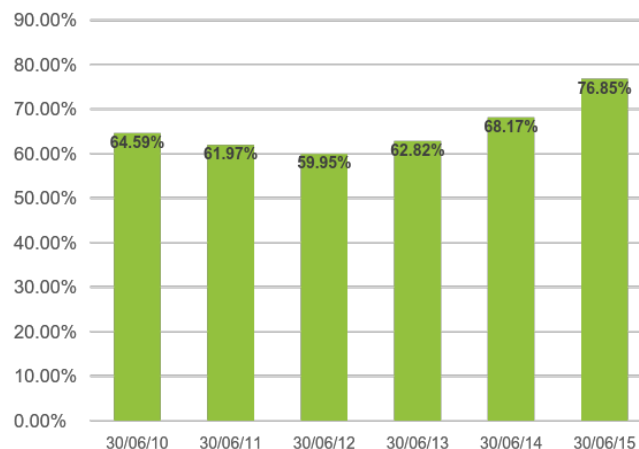
Sensitivity and Liquidity



- Compared to the typical 3~4% net interest margin for American banks and considering how it is inversely proportional to the scale of the bank, we can assume that SFB is either focusing on different financial instruments to earn income and/or it is increasing in size
- Trend in charge-offs show that losses from bad loans have fallen

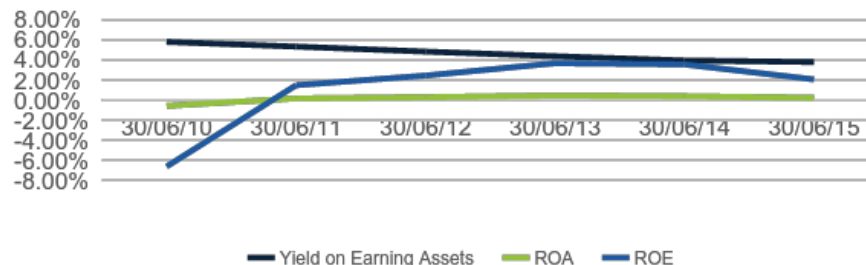
Profitability and Efficiency

Efficiency Ratios



- State Farm's focus on customer service may be a factor in increasing efficiency ratios
- Efficiency ratios of banks of same caliber average at 70.67%

Yield on Earning Assets, ROA and ROE



- Mutually owned banks answer to clients
- Lower short term profitability but promising for long term growth

Ratios taken at 6/15/2015	SFB	Peer Ave.
Net interest margin	2.63%	3.71%
Net charge-offs to loans and leases	0.72%	0.12%
Loan/lease loss provision to net charge-offs	60.58%	121.08%

Ratios (6/15/2015)	SFB	Peer
Yield on earning assets	3.78%	4.14%
Return on assets (ROA)	0.22%	1.01%
Return on equity (ROE)	2.05%	9.04%



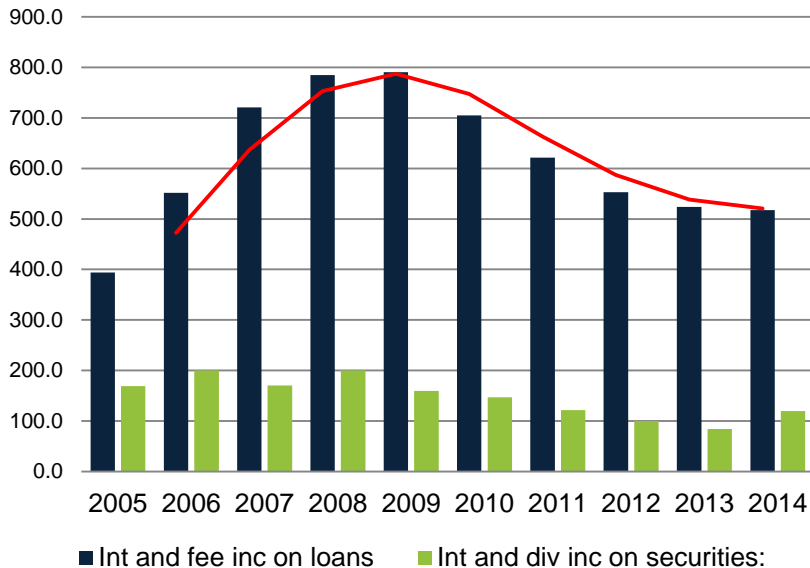
2B) Internal Factors- **Revenue and Cost**

Segregated Revenue & Expense

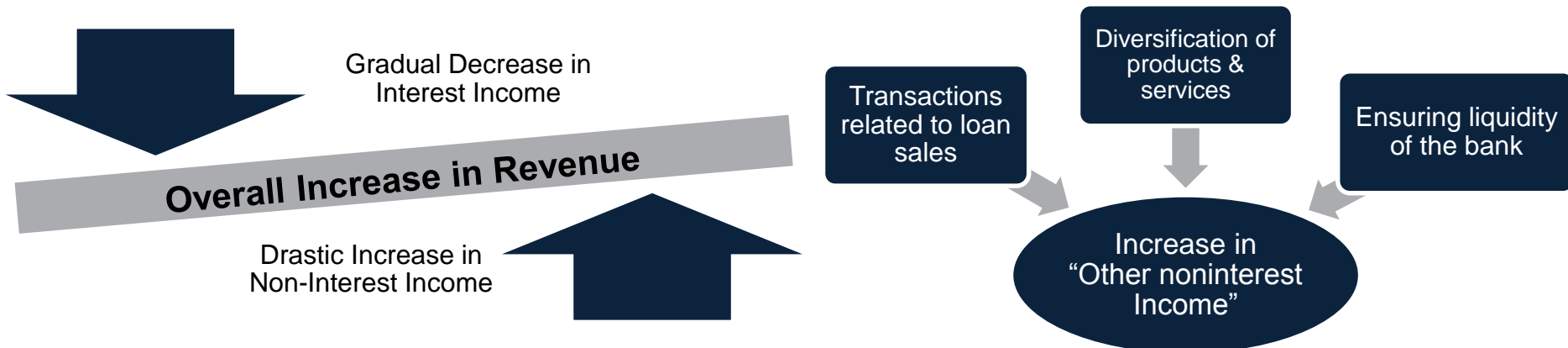
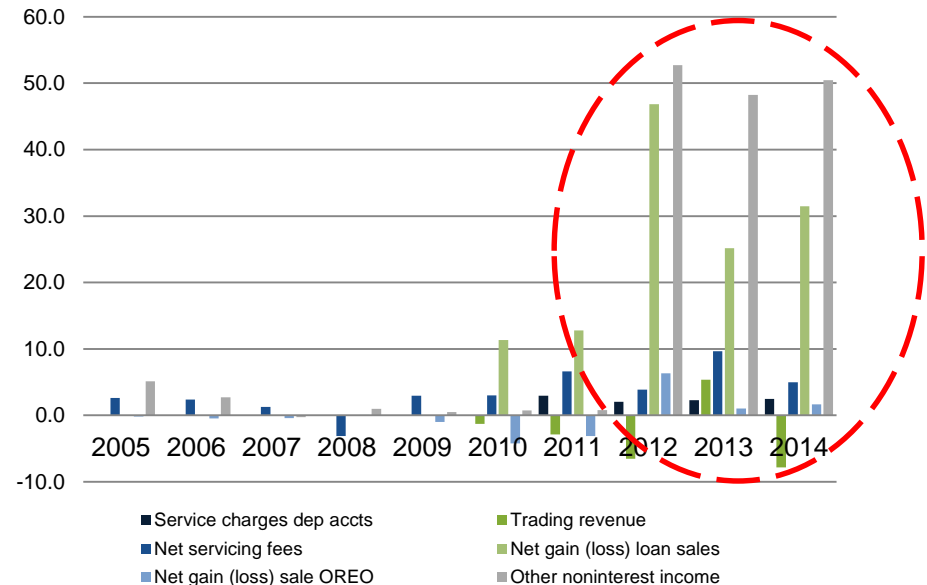


State Farm Bank, F.S.B - Segregated Revenue

Interest Income



Non-interest Income

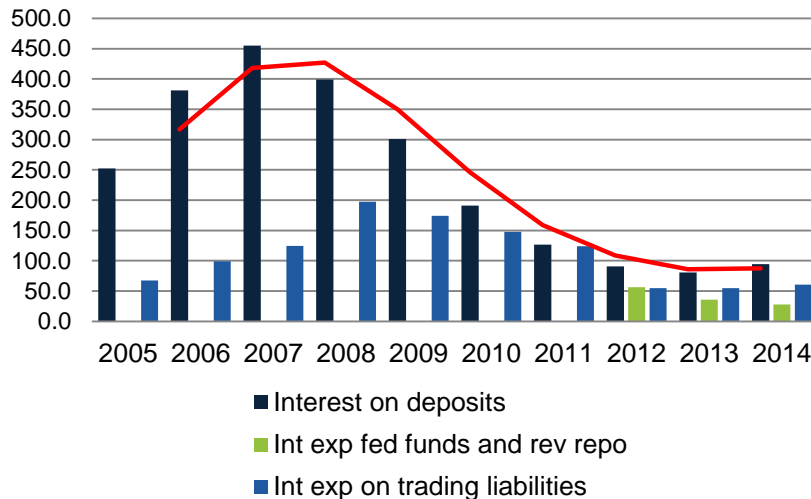


Segregated Revenue & Expense

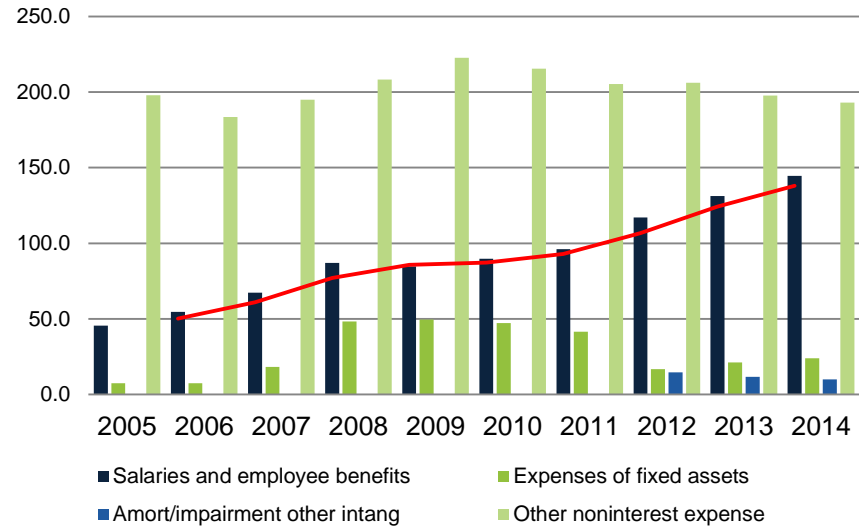


State Farm Bank, F.S.B - Segregated Expense

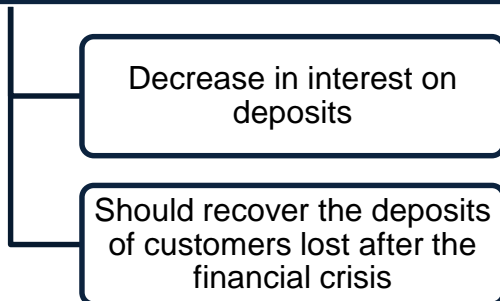
Interest Expense



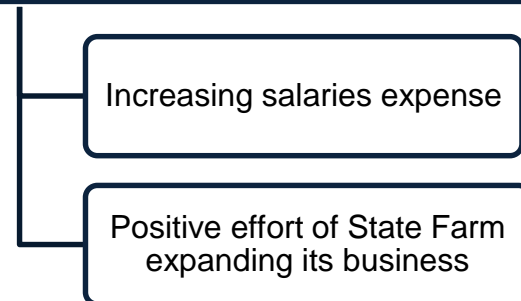
Non-Interest Expense



Drastic Decrease in the Interest Expense



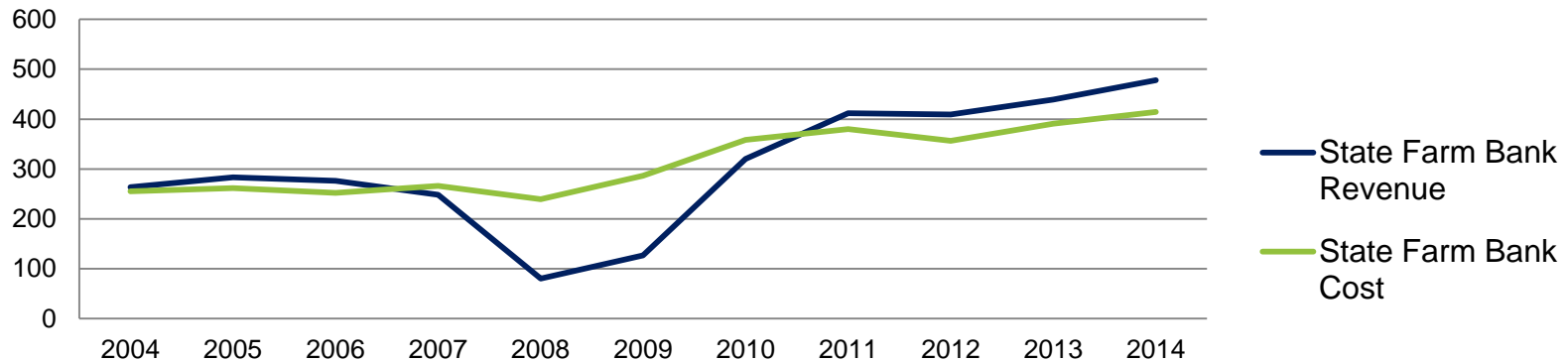
Slight Increase in Overall Noninterest Expense



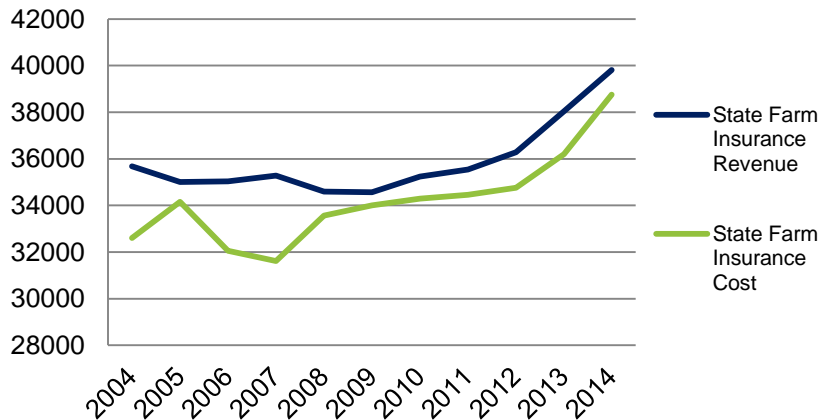
Historical Revenue and Cost



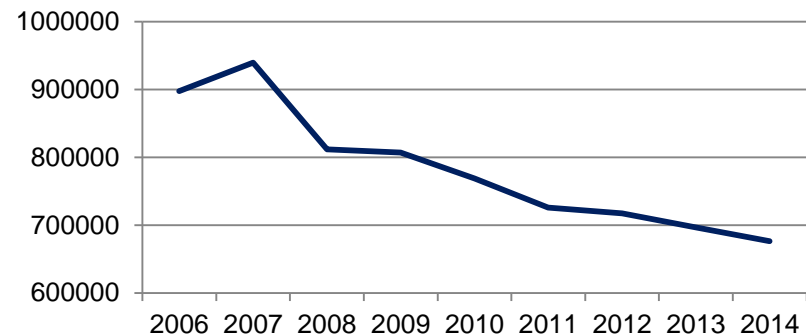
State Farm Bank, F.S.B.



State Farm Insurance



Revenue History of Commercial Banking Industry



Revenue of State Farm Bank developed more similar growth to revenue of State Farm Insurance than the to the trend of industry.

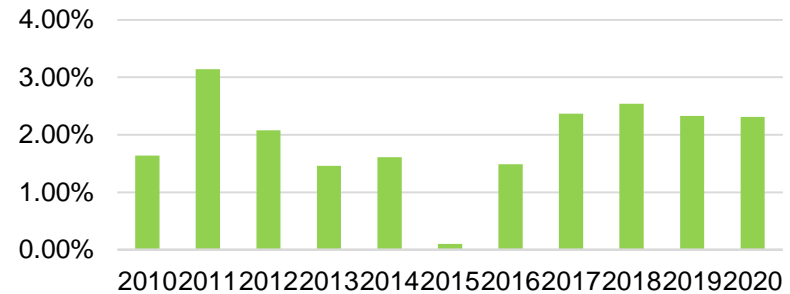
Projected Stable Increase in Revenue



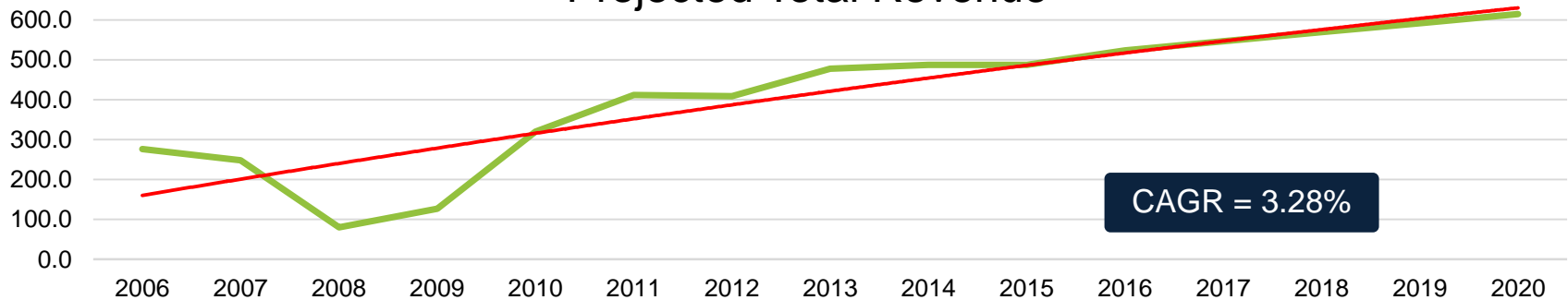
Current Net Margin



Projected Change Inflation Rate



Projected Total Revenue



Recovering from
the financial crisis

Following the
industry trends

Implementation of
technology

Diversification of
services

Steady increase in
revenue



3) Analysis & Conclusions

RECOMMENDATION: State Farm should maintain but not expand its bank



Increase in profitability ratios and diversification of services show that the industry favors SFB

By adapting to changing consumer demand, SF will be able to maintain its holistic approach while avoiding further regulations

Regulatory burdens are stringent but surpassed by SFB's test results

Stable growth in revenue and fast recovery support positive financial projections for SFB

Benefits of expanding the bank are outweighed by increased regulatory burden and existing customer loyalty



State Farm should maintain but not expand its bank