

CBI/PricewaterhouseCoopers Survey

December 2002

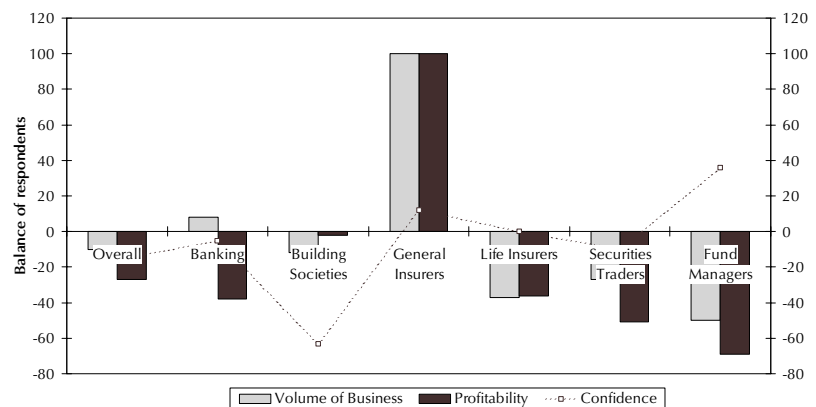
“Overall, a second quarter of reduced volumes and profitability has left the industry feeling increasingly pessimistic about its outlook”

The 53rd CBI / PricewaterhouseCoopers financial services survey showed a distinct decrease in overall business optimism, heavily influenced by the altered sentiment of two sectors in particular – building societies and life insurers. Concerns over the UK mortgage market are leading building societies to feel increasingly pessimistic, and life insurers have returned to a more neutral outlook after a burst of unexpected optimism in the last quarter. Across the industry, business with private individuals has continued its slow decline, outweighing any benefits that may accrue from improved demand in other parts of the economy. Although the industry as a whole exhibits negative sentiment, imbalances between sectors persist; general insurers continue to enjoy a boom in profitability, and fund managers have become more upbeat.

Total costs are trending down across the industry. Although some sectors are adding staff to cope with demand, the broad trend in headcount remains downward, and this is expected to accelerate in the next quarter. Despite cost reductions, profitability fell during the period, contributing to reduced optimism.

Turning to investment intentions, few sectors seem to be considering major capital expenditure in the current environment of weak demand. Those that do intend to invest are focusing on the need for efficiency. Planned expenditure on Euro-related matters has reached its lowest level since 2000, apparently reflecting the industry’s view of the political debate on UK entry. Looking to the longer term, levels of demand and competition remain the predominant concerns of respondents, and both have grown in importance from the levels of the prior quarter. Overall, a second quarter of reduced volumes and profitability has left the industry feeling increasingly pessimistic about its outlook.

Figure 1: “Although the industry as a whole exhibits negative sentiment, imbalances between sectors persist”



A balance statistic of -5% of **banks** reported a fall in optimism for the quarter. Volumes rose slightly overall, with growth across most key customer segments.

Business with private individuals remained solid, driven by continued consumer borrowing, although the rate of expansion may be slowing. Business with industrial and commercial customers also picked up after a small downturn in the previous quarter, as had been predicted. This might be indicative of economic revival in the service sector, but could also suggest a corporate need for funds and liquidity at a time when the capital markets are less accessible. Despite volume growth, average spread and fee incomes fell. This was partly due to strong competition in the mortgage and consumer lending markets, an impression confirmed by pessimistic expectations for the value of income in the coming quarter. In the search for greater efficiency, banks reduced costs during the period, which also saw headcount fall. However, profitability fell unexpectedly as cost reductions did not keep pace with falling incomes. There are hopes that continued staffing cuts will help to reverse this trend. The value of non-performing loans continued to climb. Given the low level of arrears in the personal sector, this is attributable to corporate borrowers.

Uncertainty over demand remains a key barrier to investment, but those planning capital expenditure cite a variety of motives; the need for replacement and efficiency remain high, but expanding capacity is also a priority. Marketing intentions have increased slightly, but a balance statistic of -24% of banks plan a reduction in IT investment. This may reflect concern about the general outlook, and suggests that big-ticket expenditure is being deferred in the short term. Looking to the future, competition and worries over demand remain the key concerns. However, the banks do feel positive in some areas; for the third successive quarter respondents feel more competitive relative to overseas rivals.

Among **building societies** respondents, a balance statistic of -63% reported reduced optimism during the quarter. This dramatic decline in confidence reflects a significant shift in sentiment over the UK housing market. Business with private individuals, the keystone of the mortgage boom, was reported to have declined by the largest statistic since 1994. A fall in net interest and investment income was driven by lower volumes, but reduced average incomes suggest that competition is strengthening as the mortgage market slows and participants seek to maintain share. Fees and commissions disappointed, and there are concerns about income levels going forward, a result not only of new business competition, but also the effect of redemptions on back book margins. Furthermore, costs grew notably during the quarter, a trend expected to accelerate as building societies plan to add staff in the coming period. Cost inflation, coupled with income trends, explains the fall in profitability anticipated by respondents. On a more positive note, non-performing loans continue to decline in value, underlining the extremely low level of arrears in the housing market.

Turning to the future, there is a strong expectation of increased marketing spend. Building societies seem determined to maintain market shares at a time of high re-mortgaging. The sector is also one of the very few planning to invest more in IT. The need for replacement is cited by 100% of respondents and may explain the planned growth in staff numbers, as systems struggle to process current business. In terms of the factors expected to limit business growth over the coming year, levels of demand and domestic competition are both cited as concerns by 100% of respondents. Statutory legislation also remains a worry, as the societies await the introduction of mortgage regulation.

A balance statistic of +12% of **general insurers** feel more optimistic than in the previous quarter. Performance continues to be strong, with volumes reported to have increased by all respondents. Business with industrial,

commercial and financial customers increased during the quarter, a trend expected to continue. This, in combination with the ongoing hardening of commercial rates, explains the reported growth in the value of premiums. A more unexpected response, however, was a strong expectation of more business with private individuals in the coming quarter. Expenses were reported to have fallen as the sector continued to take out costs. This reduction in expenses underpinned the increase in profitability reported by a balance statistic of +100%; a further contributing factor was the slight fall in the value of claims. However, the picture of improving efficiency may be called into question by the increase in headcount during the period, a trend expected to continue as insurers seek to take advantage of the current boom.

Although the sector's results appear buoyant, there are some indications that respondents may be feeling cautious about the future. Concerns over demand levels and domestic competition have grown from third quarter levels. Statutory legislation is also a worry for 82% of respondents. This is the highest level reported in over a decade, and reflects the expected impact on distribution channels of proposed FSA regulation of insurance intermediaries. In contrast to the optimism suggested by rising headcount, a reduction of marketing spending is anticipated, and capital expenditure plans are also negative. This implies that the sector may have different views of its longer-term outlook than it does of its short-term prospects.

After an unexpectedly optimistic third quarter, **life insurers** feel neither more nor less confident, with a balance statistic of 0%. In most respects however, the survey results suggest the sector sees itself as being in a poor position. Volumes and values of business declined during the quarter, driven by the poor performance of the financial markets and weak demand for investment products. New business continued to decline steeply. All respondents considered levels of business to be below normal, and activity declined across all customer segments, with little expectation of any improvement in the short term. After the cost inflation of the prior quarter, life companies have been making strenuous efforts to boost efficiency. Total operating costs are reported to have fallen by a balance statistic of -74%, but the reductions were not sufficient to prevent the steepest fall in profitability reported since 1994. Although headcount rose slightly during the quarter, numbers employed are expected to fall in the coming period, consistent with recent high profile redundancy announcements by some major life companies.

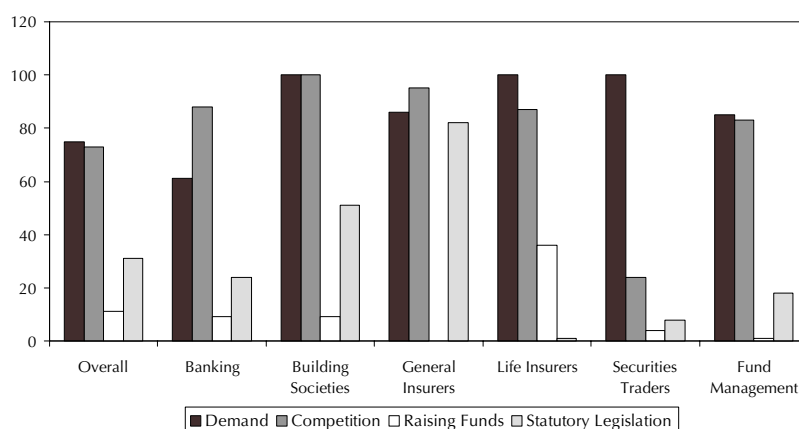
Given the weakness of investment returns and recent negative publicity surrounding the life industry, it is hardly surprising that demand levels are the predominant concern regarding future prospects. This uncertainty is also manifested in the downward trend of marketing expenditure, and the sector's reduced intentions for investment. Plans for IT spending are at a balance statistic of 0%, the lowest level seen for nine years. Looking forward, the ability to raise funds is increasingly seen as a barrier to growth, unsurprising given the capital and solvency pressures that falling markets have placed on many life insurers. However, concerns about statutory legislation, which have been consistently high for several quarters, have fallen dramatically. Perhaps life companies hope that this is one area in which they have already heard the worst.

Although a balance statistic of -10% of **securities traders** reported a fall in confidence for the third successive quarter, this is at least an improvement on the prior period. Nonetheless, the sector as a whole remains pessimistic, as participants face an ever-lengthening bear market with no apparent recovery in sight. Despite the relative stability of the UK stock markets during the quarter, respondents do not appear to be expecting a sustained rally. The volume and value of business continued to trend down during the period,

and the optimism of earlier quarters has not been sustained – growth is expected to be weak or negative across all customer segments. This is hardly surprising given current stock market levels and the weak outlook for corporate earnings. The weakness of the primary capital markets is also a contributory factor, as companies seeking finance continue to turn to the banks for their capital needs. However, recent reports that online trading has increased modestly during the fourth quarter may offer some grounds for hope.

Securities houses have responded to the revenue environment by continuing to cut costs and headcount, and both trends are expected to continue into the next quarter. An anticipated rise in training costs is attributable to the growing regulatory burden on the sector. The overall profitability of business was reported to have fallen by a balance statistic of –51%. This may reflect the reluctance of managers, especially those unused to bear market conditions, to cut too far into their infrastructure in the search for efficiency. Although marketing spending is expected to increase slightly, capital expenditure will be lower in the coming year than in the last. An expectation of reduced IT investment is particularly surprising, given the sector’s continuing spend on industry-wide issues such as straight-through processing. Level of demand remains the factor most likely to limit business development, cited by 100% of respondents.

Figure 2: Factors cited as likely to limit respondents’ ability to increase business levels over the next twelve months



A balance statistic of +36% of **fund management** respondents feel more optimistic about their situation, despite a steep fall in reported business volumes. Expectations for business with industrial and commercial companies in the coming period have fallen. Domestic demand expectations are unsurprisingly low, indicating that the sector may not be hopeful of a strong ISA season. In contrast, fund managers are hoping overseas business will be more resilient; a balance statistic of +52% hope to see European markets open up further to their products in the next quarter. On the cost side, the sector continues to pursue a strategy of outsourcing in the search for greater efficiency. However, fund managers are finding they need to keep staff on during the transition to outsourcing; consequently, headcount levels remained more stable than had been expected during the period. Where outsourcing has been achieved, staff are being retrained to work within the new architecture, driving up training costs. Nonetheless, headcount is expected to fall steeply in the coming period, and it is hoped that this will enable the sector to improve its profitability.

Looking forward, marketing expenditure is expected to increase as fund managers seek to capture retail market share during the ISA season. On the

capital expenditure front, no change is anticipated in the level of IT investment; but the number of respondents hoping to use investment to provide new services has increased to 82% from 47% in the prior period. This suggests that fund managers, having focused on the search for efficiency, are trying to drive improved functionality from their systems, with the aim of selling more services to existing customers, and improving their offering for foreign customers. However, fund managers are concerned about future demand for their product; this is cited as the factor most likely to affect the future level of business and limit capital expenditure. Not only is the UK market seen as relatively saturated, but competition in the overseas market, where fund managers are hoping to expand, is increasingly worrying respondents. Overall, although fund managers feel optimistic, they remain preoccupied about a number of uncertainties affecting the outlook for their business.

New Economy: e-business section

The e-business section of the survey again showed positive growth in the value of financial services business transacted online, with a balance statistic of +45% reporting an increase in the total value of their Internet business. However, the level of growth is still disappointing respondents; a balance statistic of -25% said that the change did not meet their expectations. Financial services companies continue to interact through the web with customers to a far greater degree than with suppliers. This low level of supply-side internet usage is attributable to the IT infrastructure already assembled by the financial services industry before the advent of the web – many of the benefits of electronic transmission have already been realised.

The major barriers to e-business development have not altered significantly, although there are some low-level changes. Firstly, regulation has increased as a concern for the second successive quarter, possibly due to concerns about European regulation of areas such as distance selling. Secondly, the speed at which the Internet works is seen as less of a barrier; it was cited by 23% of respondents, down from 34% in the previous period. This reflects the increasing adoption of broadband technology, as highlighted in a recent report showing that the UK now has over one million broadband users.

In terms of the preferred strategic routes to e-business growth, respondents continue to focus on the web-enabling of existing operations. It is now a strategy adopted by 78% of respondents. In contrast, the second and third most popular options – extending current activities and using collaborative alliances – have declined slightly in popularity during the period.

The overall picture for e-business within financial services is one of slow but steady growth. This is in contrast to the instability seen in other areas of financial services over the last year, and is particularly notable given the generally accepted image of e-business as volatile. In the present climate, e-business is the least of many financial services companies' worries.

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About this survey

The survey was carried out between 25 November and 4 December 2002. A total of 103 companies responded including banks, building societies, finance houses, securities traders, fund managers, commodity brokers, private equity, insurance companies and insurance brokers.

Further contacts

Copies of the full survey are available from the Confederation of British Industry, tel: 020 7395 8071, email address Pubsales@cbi.org.uk. The price for a single quarter for members is £46 and for non-members is £83; an annual subscription for members is £180 and for non-members is £325.

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