

# Financial Services Survey

## CBI/PricewaterhouseCoopers Survey

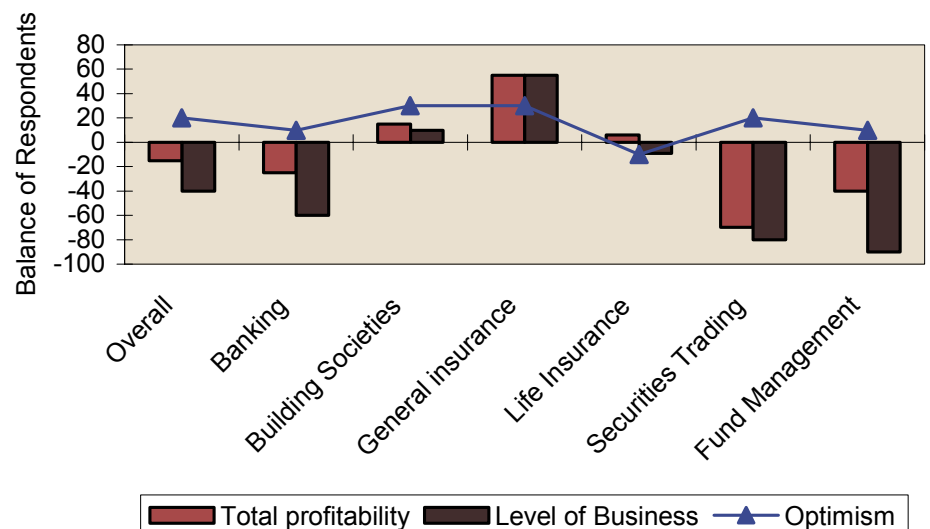
March 2002

### “Overall business confidence increases, despite contradictory supporting evidence”

The 50<sup>th</sup> CBI / PricewaterhouseCoopers financial services survey showed a distinct improvement in business optimism after the last quarter, even if the underlying picture remains mixed. As in the last briefing, in some sectors the survey appeared to reveal a disconnection between confidence levels and the supporting data. While many respondents are at their most optimistic since 2000, business volumes remain low in most sectors. However, there is an overall expectation of a return to growth in the current quarter, particularly in the personal sector.

The industry continues to cut costs, and prospects for employment remain gloomy with a balance statistic of -26% indicating further net job losses. Similarly, investment intentions are down; notably, despite the return of the Euro to the political agenda, there appears to be a lack of commitment to investment in Euro preparation across the industry. Although a number of banks, securities traders and fund managers have identified a need for capital expenditure in this area, other sectors run a greater risk of leaving themselves vulnerable if the government were to proceed with a referendum and then seek a rapid transition towards full Euro membership.

**Figure 1 “in some sectors the survey appeared to reveal a disconnection between confidence levels and the supporting data”**



Business confidence in the **banking** sector has increased notably since the last quarter, and is now at its highest level since March 2000, showing an upward swing in balance statistic terms of +21%. Banks seem to be basing their optimism on hopes of further growth in their business with private individuals, which registered positive trends for the sixth quarter in a row. Expectations for growth in other sectors, particularly industrial and commercial business, remain low. However, banks are expecting non-performing loans to remain stable, which may indicate cause for optimism.

Banks are predicting an increase in overall profitability of business for the next three months, with a balance statistic of +23%. At the last briefing, banks were expecting to take employment out, a trend which is expected to continue. Respondents to the survey cite staffing levels as the focus of planned cost reductions, with a balance statistic of -63% indicating a substantial planned headcount reduction over the next three months. However, the outlook for investment is also distinctly negative, with a decrease in capital expenditure forecast for the coming year. Indicators for business prospects over the next twelve months suggest that domestic competition remains a pressing issue, unsurprisingly coupled with worries over levels of demand. Statutory legislation remains a source of concern for banks, reflecting continuing nervousness about the regulatory agenda.

In common with the banks, **building societies** experienced a distinct rebound in business confidence during the quarter, reporting a balance statistic of +33%, the highest level of optimism since March 2001. Owing to their close linkage to the UK housing market, building societies appear to have undergone a shorter cycle than the banks. After three successive quarters when fears of a housing market downturn depressed business confidence, the apparent recovery of house prices in 2002 has led to a change in outlook for the sector. Confidence is supported by growing volumes of business among private individuals, a trend which is expected to continue. Another source of confidence was a further decrease in the value of non performing loans. Arrears levels are currently very low as the economic slowdown has not translated into a significant rise in unemployment.

However, the picture for the building societies is not universally rosy. During the quarter, staff were taken on rapidly to service the growth in volumes, causing transaction costs to rise. And although employment levels are not expected to increase, respondents are anticipating further growth in training costs. On the investment front, building societies plan to spend more on IT, but in other areas investment levels appear low, particularly for Euro-related matters. With an expectation of growth in total operating costs, building societies might be creating problems for the future should the housing market turn down.

In terms of the business outlook for the coming year, building societies share some of the banks' concerns. They remain worried about domestic competition, but less so about lack of demand. Statutory legislation remains a concern, but to a lesser extent than for the banks.

**General insurance** experienced a marked recovery in business confidence during the quarter, reaching its highest level in over a year. This appears to be largely attributable to the positive rating environment following the events of September 2001, which has served to slow down or even reverse what was otherwise looking like a downturn in the insurance cycle. Trends in business volumes and premium income are expected to remain positive, with respondents hoping that strong growth in personal lines during the quarter will continue.

Reflecting this optimism, cost levels are still growing as insurers take on staff and spend more on training. For the second quarter running, general insurers and building societies were the only sectors to add employment. Total operating costs rose substantially with a balance statistic of +34% of respondents reporting an increase. This continuing increase in the cost base leaves the sector exposed to future downturns in the cycle.

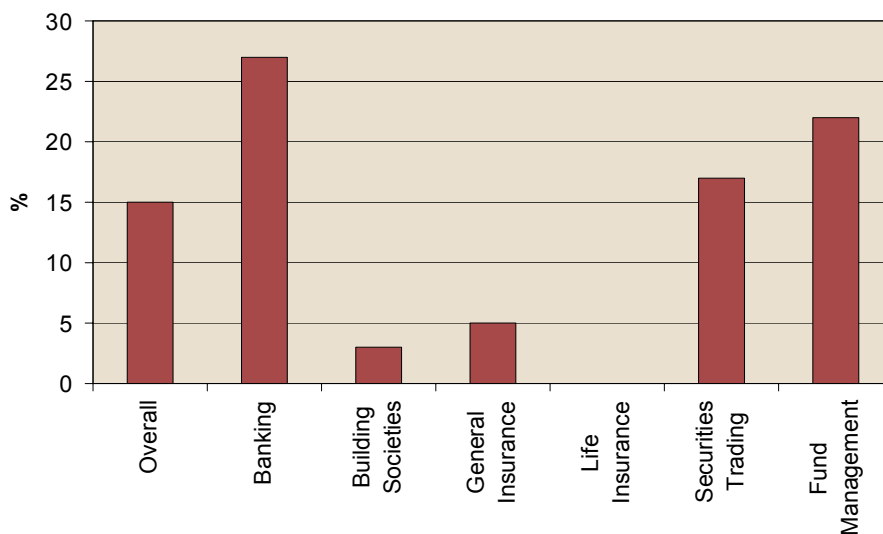
On the other hand, investment in IT is expected to decrease for the first time since 1999, and Euro related investment remains the lowest priority. Respondents cited domestic competition as the factor most likely to limit business growth over the coming year.

Although the **life insurance** sector reported a modest improvement in business confidence during the quarter, it remains essentially pessimistic in its outlook, with a balance statistic of -7%. Despite positive trends in business volumes and premium income, and a renewed determination to cut costs, the sector remains concerned about competition, low demand and an uncertain future.

In terms of profitability, the responses look contradictory. Business volumes across all market segments are forecast to increase, and competition is expected to remain strong, but average commissions are expected to decline. After allowing total operating costs to grow in the last quarter of 2001, expenses have been falling. This trend looks set to continue, driven by expectations that staffing levels and training expenditure will be reduced in the coming three months. Overall, the outlook for profitability levels is not good (balance statistic of -24%), reflecting a continuing divergence between the profitability of existing business and the outlook for new business in the "1% world".

Looking forward to the year ahead, the reasons for the sector's pessimism show no signs of abating. Uncertainty over demand and business prospects, worries about domestic competition, and statutory legislation are identified as concerns. The continuing bad publicity for the life industry appears to be creating a sceptical customer base in a market where products need active selling. Capital expenditure is also declining; and like general insurers and building societies, life firms are not planning to invest in Euro-related matters.

**Figure 2: Respondents citing Euro related matters as a reason for expected capital expenditure over the next twelve months**



A balance statistic of +21% of **securities traders** are optimistic about the overall business situation. The sector may have reported its eighth successive quarter of lower business volumes and commission income, but ever-optimistic respondents expect to see volumes and profitability increase in the coming quarter. So what is the basis for such optimism? On the upside, the end of the tax year is likely to generate a temporary increase in volumes, and the expansion of hedge fund activities in the current environment gives some cause for optimism on business volumes. In a more negative vein however, uncertainty over world events is leading to a genuine lack of direction in the financial markets. Also, as few of the current workforce have experienced a protracted bear market, expectations for a speedy turnaround might be misplaced. The FTSE100 index shows no signs of a significant recovery, and it may be that the sector has again called the bottom of the cycle too early. In the area of private individuals especially, last quarter's hopes of a pick-up in business have proved to be overoptimistic.

Costs did not appear to have been well controlled during the quarter, but securities traders intend to trim total expenses in the coming months. A reduction in headcount is expected, which may take the form of back-office outsourcing. In contrast, training expenditure is expected to rise, reflecting the need for ongoing regulatory updates and possibly a focus on straight through processing (STP). Another indication that the sector might not be as bullish as headline optimism levels suggest, is that the decline in capital investments is expected to continue, with respondents stating uncertainty over demand and the prospects for business as the main limiting factors. Levels of demand are also cited as the most prominent threat to business expansion over the coming year.

The optimism of securities traders contrasts with the fall in business confidence in **fund management**, their key area of custom. After a strong increase during the last quarter, confidence declined by 32 percentage points to a balance statistic of +16%, suggesting that expectations of a recovery had been overplayed. Respondents reporting heavily reduced

levels of business and income streams across all areas of activity during the quarter, with the negative trends expected to continue. This might lead critics to question the basis for any optimism, although reported decreases in costs suggest the sector is managing the downturn well. Headcount reductions in the quarter were marked, with a balance statistic of -78% for numbers employed. This was the second consecutive period of significant reductions; in the event of an upturn in business, the sector will need to demonstrate improved productivity to operated at these reduced staffing levels.

Fund managers are also the only group in this briefing planning to spend more on capital investment in the next twelve months than in the previous period, with all respondents giving the need for increased efficiency as the prime reason for expenditure. As in many other sectors, uncertainty over demand is the factor thought most likely to limit investment and the expansion of business.

### **New Economy: e-business section**

The survey showed a continuing increase in the total value of business transacted over the internet, and a significant milestone was reached: For the first time since the introduction of the New Economy section to this survey, the increase in online transactions matched the expectations of respondents. It seems that financial services businesses are becoming more realistic in their projections for e-business.

A further significant milestone is likely to be reached in the next twelve months: Currently, the web accounts for between 1% and 10% of financial services customer transactions on average; over the course of the coming year this is predicted to increase to 11%-20%.

On the supply side however, the number of businesses initiating transactions with suppliers via the internet remains below 1%, with little expectation of an increase. This is lower than in other sectors, but is not surprising, given the fact that premises and staff costs account for the majority of expenses within most financial services businesses.

Barriers to e-business development remain much as before. 69% of financial companies are frustrated by customers' lack of understanding of the infrastructure they have spent so much trying to develop. Lack of effective security standards is the number two concern; many organisations are still struggling with IT security issues, a fact highlighted in the forthcoming DTI Information Security Breaches Survey. The slow speed of Internet transactions is a close third (27%).

In terms of the e-business strategies adopted by the sector, extending and web enabling current activities remain by far the most popular options. Some are considering collaborative alliances, but there is little enthusiasm for investing in start-ups or 'greenfield' operations.

Finally, financial services businesses are less concerned about competition coming from corporates outside their sector. Within the financial world, most see e-businesses and e-banks as minimal threats, citing instead incumbent players, banks and insurers as the most likely sources of competition.

This bulletin is produced periodically to address important issues affecting the financial services industry. If any of your colleagues would like to be added to the mailing list or if you do not wish to receive further editions, please write to:

Kirsty Shepherd  
PricewaterhouseCoopers  
Southwark Towers  
32 London Bridge Street  
London SE1 9SY or send an email to:  
kirsty.shepherd@uk.pwcglobal.com

PricewaterhouseCoopers ([www.pwcglobal.com](http://www.pwcglobal.com)) is the world's largest professional services organisation. Drawing on the knowledge and skills of more than 150,000 people in 150 countries, we help our clients solve complex business problems and measurably enhance their ability to build value, manage risk and improve performance in an Internet-enabled world.

PricewaterhouseCoopers refers to the member firms of the worldwide PricewaterhouseCoopers organisation. PricewaterhouseCoopers provides a full range of business advisory services to leading global, national and local companies and to public institutions. These services include audit, accounting and tax advice; management, information technology and human resource consulting; financial advisory services including mergers & acquisitions, business recovery, project finance and litigation

## About this survey

The survey was carried out between 25 February and 13 March 2002. A total of 124 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](mailto: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.

For further information about this bulletin, please contact Kirsty Shepherd, PricewaterhouseCoopers, tel: 020 7804 7718.

To discuss the implications for the various sectors, please speak with your usual PricewaterhouseCoopers contact or one of the following people on 020 7583 5000.

### Banking

John Hitchins

### Building Societies

Peter Jeffrey

### Capital Markets

Phil Rivett

### Fund Management

Simon Jeffreys

### Insurance

Ian Dilks

This bulletin is produced by experts in this particular field at PricewaterhouseCoopers. It is not intended to provide specific advice on any matter, nor is it intended to be comprehensive. If specific advice is required, or if you wish to receive further information on any matters referred to in the Bulletin, please speak to your usual contact at PricewaterhouseCoopers or those listed in this Bulletin.