Financial Services Survey

PRICEWATERHOUSECOOPERS

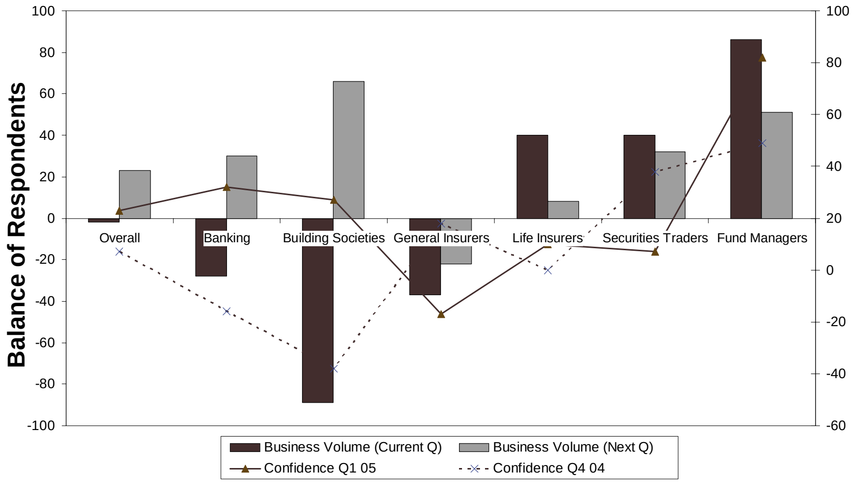
CBI/PricewaterhouseCoopers Survey

March 2005

"The industry moves to its most optimistic position for a year…
…it is also notable that every major sector expects to expand headcount"

The 62nd CBI / PricewaterhouseCoopers financial services survey reveals mounting confidence as the industry moves to its most optimistic position for a year, with sentiment improving in most sectors. Life insurers, securities traders and fund managers report stronger levels of business, as customers take heart from financial market stability. Banks and building societies continue to suffer from the slowdown in mortgage and other lending, but make surprising forecasts of recovery despite the weak trading environment. General insurers stand out as the only major sector feeling less confident, with volume declines expected to continue as the insurance cycle turns down. Business with commercial customers has weakened across the industry, though with some variation between sectors; respondents continue to rely on the retail customers, with all major sectors forecasting growth from this segment.

Figure 1: "General insurers stand out as the only major sector feeling less confident"



The aggregate picture of cost levels suggests that expenses were managed effectively during the quarter, with steady business volumes allowing profitability to rise. However, this view conceals considerable contrasts; the banks have maintained a strong focus on efficiency but several sectors have been actively recruiting and report a rise in expenses. It is also notable that every major sector expects to expand headcount in the coming quarter; the most positive employment outlook recorded for several years.

Looking further forward, respondents sustain their optimistic outlook, albeit with a degree of caution. On balance, a small majority plan to invest more in IT and physical infrastructure, but the need for greater efficiency has become the predominant motive and suggests that not all this spending is discretionary. Although regulation varies as a priority for investment, building society and insurance respondents in particular remain concerned about its impact and see compliance as a major driver of expenditure.

A balance statistic of +32% of **banking** respondents felt more optimistic during the quarter, a surprising upswing given some of the sector's other responses.

Volumes of business were reported to have fallen, with reduced commercial custom confirming the impression of weakness in the UK economy. Business on the retail side was reported to have been flat, as the banks' wide product range cushioned them from the impact of declining mortgage demand, although slight widening of spreads enabled the value of income to remain steady. Despite these unexciting results, survey respondents are positive when looking to the coming quarter. Business volumes are forecasted to grow by a balance statistic of +30%, with a figure of +58% expecting to do more business with private individuals. Considering current high street gloom, the slowing mortgage market and modest economic forecasts, these are unexpected predictions. It will be interesting to see if the banks' new wave of optimism is well founded.

On the expense side, survey responses point to strong reductions in the banks' cost base. Non-performing loans appear to remain well controlled, in line with recent results announcements from the major banks. Nonetheless, marketing expenditure is expected to grow, and a balance statistic of +57% plan to increase headcount – the highest level in over ten years. In the area of capital expenditure, branch investment continues as the banks seek to generate more income from their networks. In spite of the sector's renewed confidence, other results sound a more cautious note; IT spending remains flat, with efficiency improvement the most commonly cited driver of investment.

The **building societies** sector reports a strong swing to positive sentiment, with a balance statistic of +27% feeling more optimistic after the prior quarter's figure of -38%. In common with the banks, there was a surprising contrast between weaker business in the current period and forecasts of an imminent recovery. On one hand, a balance statistic of -89% report lower volumes and less business with private customers; on the other hand, balance statistics of over +60% expect to see growth in volumes and commission income in the coming quarter. Despite the slowdown in most types of mortgage lending, societies are hoping for a broad recovery in the property market, with growth forecasted to come both from private individuals and commercial customers. This optimism is hard to reconcile with current indicators of savings and mortgage demand.

In the area of costs, the survey results seem to contain some inconsistencies. The sector continues to expand headcount, presumably with a view to the expected recovery, but costs are reported to have been controlled. Furthermore, additional expense reductions are forecasted, although respondents predict growth in marketing and training expenditure. Arrears are also reported to have increased and are expected to expand at a faster rate in the next quarter. This contrasts with the experience of the banks, which have more diversified credit risk and benefit from current low levels of corporate delinquency. The societies expect to authorise more capital spend across all areas for the second quarter in a row, but this is hard to analyse as more than 90% of respondents cite several motivating factors. However, planned spending on legislation and regulation has jumped noticeably, reflecting increased investment in Basel II implementation.

A balance statistic of -17% of **general insurers** are feeling less optimistic, as volumes of business were reported to have declined for the third successive period. These results confounded the expectations of the last quarter, and the slowdown is forecasted to continue. Reduced volumes were noted in both commercial and personal lines, with insurance brokers corroborating the decline in commercial business. Greater competitive pressures also appear to be leading to a softening of both personal and commercial rates, trends that are expected to continue into the next quarter. The downturn in rates appears to have impacted overall profitability, which was reported to have declined.

Nonetheless, respondents expect a rise in profitability in the next period, and improving equity and bond markets could be one reason.

On the expense side, total operating costs have resumed their upward march after a single quarter of cost reduction. Staff costs are a driver; respondents report higher employment costs and further rises are expected, a surprising result given the pessimism over growth. General insurers also appear to be intensifying their marketing efforts in response to volume declines, with spend expected to rise by a balance statistic of +71%. There is some inconsistency as, despite a rising cost base and falling volumes, average costs per transaction are predicted to fall. On a more positive note, a relatively benign environment has seen the value of insurance claims fall for the second quarter running. Respondents plan to increase their IT spend in the coming year, and while improving efficiency is a goal for 97% of respondents, compliance spending is still a priority. Almost three-quarters of respondents expect regulatory issues to drive investment in the coming year.

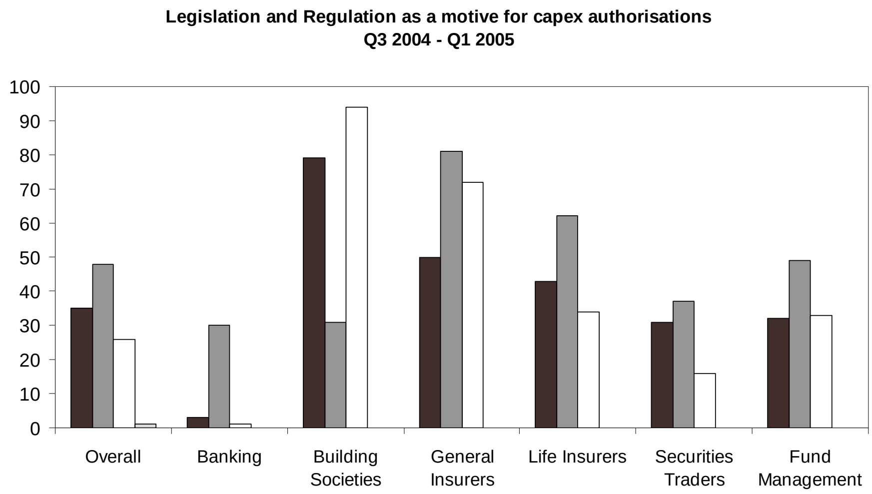
The survey shows that a balance statistic of +10% of **life insurance** respondents felt more optimistic during the quarter. As predicted in December, the onset of depolarisation generated growth in volumes and premium income, with many new products receiving their launch in the first quarter of 2005. Consumers are returning to the long-term savings market, encouraged by the improvement in equity markets, but the competition among life companies is fierce. The underlying impression from the survey is one of volume growth over profit, as life companies offer significant discounts to find places on multi-tie panels. In contrast to the reported growth in income, overall business profitability barely improved, and is expected to decline by a balance statistic of -26%. After the initial boost of depolarisation, respondents also predict slower growth in volumes going forward.

Life companies report a rise in total operating costs, reversing the trend of four successive quarters and contradicting predictions of a lower expense base. Additional cost increases are expected over the next three months, as respondents grow numbers employed and training expenditure in anticipation of higher volumes. The rise can also be attributed to marketing costs; a balance statistic of +60% expect more marketing spend in the coming year as the sector seeks to boost volumes. Despite the growth in expenses, life insurers expect to authorise less capital expenditure in the coming year as the sector maintains its prudent approach to investment.

Securities traders took an optimistic view during the quarter, with a balance statistic of +7% feeling more positive. Levels of business and the value of income were both reported to have increased, as traders benefited from the rising equity markets to boost volumes and raise their commission rates. Moreover, growth is expected to continue with a majority of respondents forecasting further growth in business and income levels. In another positive development, all customer segments were reported to have generated more business. Private customers are continuing their return to the market, and respondents also identified strong growth from financial customers, probably reflecting the importance of hedge funds to the securities houses. Overall, traders seem to be growing more confident in the resilience of the stock market's recovery. Even so, the concentration of hedge fund business could represent a potential vulnerability if regulatory attention were ever to lead to reduced turnover from this customer segment.

The confidence of traders also shows in the areas of cost and investment. Staffing levels were reported to have risen, with a balance statistic of +68% planning to add to headcount in the coming quarter. Marketing expenditure is expected to rise for the sixth consecutive period and more capital expenditure is foreseen, both on IT and to accommodate the growing workforce. However, uncertainty over demand remains the largest barrier to development and the factor considered most likely to limit investment. For all their upbeat forecasts, traders appear to remain uncertain about the longer-term prospects for their business.

Figure 2: "Although regulation varies as a priority for investment, building society and insurance respondents in particular remain concerned about its impact and see compliance as a major driver of expenditure"



Respondents in **fund management** report the most optimistic views of any sector. A balance statistic of +82% feel more confident, completing a turnaround in sentiment from the position of last summer. Significant increases in business volumes and commission income were reported as the stronger stock market levels of late 2004 were sustained into the first quarter. Business trends with both institutional and retail customers remained positive, indicating a balanced growth profile which should be a positive development for the sector.

Against the background of higher revenues, fund managers oversaw a general increase in costs. This was largely driven by strong growth in hiring; a balance statistic of +58% employed more people during the quarter and this trend is expected to continue. A large majority expect training costs to climb, due to the requirements of regulation. Combined with plans for more marketing expenditure, these factors led respondents to predict further growth in overheads. Nonetheless, fund managers expect revenue growth to offset higher expenses; profitability was reported to have increased and this improvement is forecasted to continue into the summer. Reviewing their investment plans, fund managers expect to authorise more spending on IT for the fifth time in six quarters. A further sign of confidence is that the sector appears much less concerned about the potential impact of falling demand, both as a limitation on investment and as a threat to business prospects. Overall, fund managers remain as sentiment-driven as ever, with income, costs and investment plans closely tracking stock market performance – whichever direction it takes.

e-business section

The value of internet business continues to rise steadily, at growth rates similar to those of a year ago. Business continues to be derived from the 10-20% of customers who use the Internet, as is common in other sectors; a recent APACS report showed that 10% of all credit card spending in 2004 was conducted on-line. Most financial services providers expect the value of Internet business to continue to rise, as both the proportion of customers transacting on-line and the value of each customer's transactions increase.

However, for the vast majority of respondents, the internet is set to remain an additional channel rather than a substitute. Few expect more than a third of their customers to transact via the Internet in the next twelve months, and the top two inhibitors remain unchanged. Firstly, many customers simply prefer to use other channels; and secondly, customers continue to have concerns about security and data protection. The challenge for financial services companies and banks in particular is to demonstrate to their customers that transacting over the Internet really is safe.

There has also been a big jump in responses naming the speed of the internet as a critical barrier to growth. This seems counter-intuitive, given the continued rollout of broadband to UK households, but several issues remain with broadband. The cost puts off many consumers; and a recent survey showed that a third of broadband customers were dissatisfied with the service they receive from their provider. In addition, the speed of UK entry-level broadband is still ten times lower than in countries such as South Korea or Japan that have invested heavily in their infrastructure. It seems that businesses are realising that the rollout of UK broadband is not going to solve all speed issues.

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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 Parker
PricewaterhouseCoopers
Southwark Towers
32 London Bridge Street
London SE1 9SY

or send an email to:
kirsty.parker@uk.pwc.com

About this survey

The survey was carried out between 23rd February and 9th March 2005. A total of 99 companies responded including banks, building societies, finance houses, securities traders, fund managers, commodity brokers, private equity firms, 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 bookshop@cbi.org.uk. The price for a single quarter for members is £60 and for non-members £95; an annual subscription for members £210 and for non-members is £360.

For further information about this bulletin, please contact Kirsty Parker, PricewaterhouseCoopers on 020 7804 7718.

To discuss the implications for the various sectors, please speak to 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
Pars Purewal

Insurance
Clare Thompson