

## CBI/PricewaterhouseCoopers Survey

June 2002

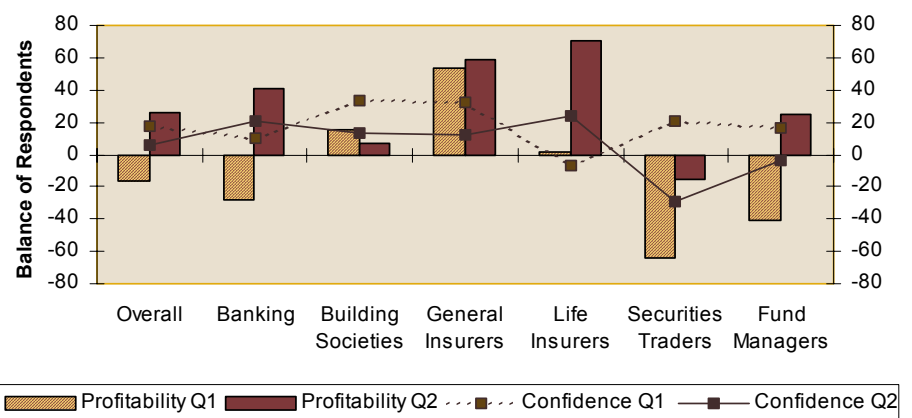
***“Overall optimism continued to rise, supported by improving volumes – but there is growing divergence between sectors”***

The 51<sup>st</sup> CBI / PricewaterhouseCoopers financial services survey showed another increase in overall business optimism, reflecting rising volumes over the past three months and expectations of continued strong volumes by almost all sectors. Overall optimism levels, while up, are not rising as strongly as in the last quarter, indicating that expectations and reality appear to have moved closer together. There is, however, a marked contrast between sectors. The more optimistic sectors include the banks, building societies and general insurers, which showed the strongest volume growth. However, those sectors more heavily geared to the stock markets reported lower business confidence on the back of weaker levels of activity – with the surprising exception of life insurers. The financial services industry continues to benefit from the consumer boom, and the industrial and commercial sectors appear to have given some cause for optimism during the quarter.

Respondents in most sectors continue to manage their costs prudently in the current environment. Headcount appears to have stabilised across the financial services industry after several periods of staff reduction, and although total costs have edged upwards, costs per transaction remain under control. There seem to be, on average, plans for capital expenditure increases in IT, with efficiency gains cited as the most common reason to invest.

Despite overall levels of optimism, some sectors foresee weakness in the third quarter, with lack of demand a pressing concern for some. Business confidence going forward is tempered by uncertainty over the future direction of interest rates and economic data, and questions of how long the consumer boom can continue.

**Figure 1: “Expectation and reality appear to have moved closer, but there is divergence between sectors”**



Finally, it is worth remembering that this survey was conducted before the recent stock market turmoil caused by concerns over accounting practices. Falling stock markets have led to concerns about insurance company solvency, contributing to steep reductions in insurance company valuations. The results of this survey should, arguably, be considered with these developments in mind.

Optimism in the **banking** sector rose during the quarter, reaching its highest level since 2000 with a balance statistic of +21%. This improvement in sentiment was partly driven by the continuing boom in the personal sector. However, for the first time in over a year, volume growth in the industrial and commercial sector was a factor, indicating a possible pick-up in that part of the economy. The bullish attitude of the banks was reflected in the first reported increase in headcount for two years, albeit only slight. Employment levels in the sector appear to have stabilised, with a balance statistic of +2% expecting an increase in staffing over the coming quarter. The banks turned in a good cost control performance during the quarter, with overall costs flat and growing volumes reducing costs per transaction. A balance statistic of +41% of respondents reported increases in profitability.

The only fly in the banks' ointment appears to be a rise in non-performing loans, a trend which is expected to continue. In the personal sector, this is related more to the rapid growth in volumes than to any fundamental deterioration in the credit situation, but in the corporate sector, this may indicate that more problems are surfacing. Reviewing their outlook, banks are less worried than in the previous quarter about factors limiting their business. Concerns over levels of demand, domestic competition and statutory legislation have all fallen, with the last point probably explained by the banks' increasing familiarity with N2, and the deferral of Basel II implementation until 2007. Although investment is expected to increase over the coming year, the focus will be on the search for efficiency, not to provide new services, with only 24% of respondents citing this as a factor – the lowest level for over a decade. This suggests that the banks may be questioning just how long the current consumer boom can continue.

A balance statistic of +13% of **building societies** remain optimistic about their business situation. Volumes of business continue to be high, with the personal sector still acting as the engine of growth. Competitive pricing among lenders, one side effect of the personal mortgage boom, continues to erode spreads. To deal with demand, building societies have added staff and boosted training budgets, but the high volumes being processed have reduced costs per transaction. Low interest rates and low unemployment have helped control non-performing loans, supporting profitability levels.

However, the outlook for building societies does not look entirely positive. The fall in confidence levels from the high level of the previous quarter may indicate worries over the impact of a correction in the housing market on current profitability levels. Building societies expect volume growth to be softer, rising by a balance statistic of +10% over the next quarter, in contrast to a balance statistic of +80% over the past quarter. There are other signs of uncertainty over future prospects. The recent additions to the cost base raise questions over respondents' ability to scale down their activities if volumes decline. Staff levels are expected to fall in the coming quarter, and investment levels are expected to reduce, although the Euro has finally registered as a subject

for investment. While respondents do not report excessive concern about limitations on their business, building societies appear to reflect recent reported concerns about a possible correction to house price growth.

In the **general insurance** sector, confidence has fallen from the high levels of the previous quarter, but remains positive with a balance statistic of +12%. The sector still appears to be enjoying a cyclical upswing, with levels of business from industrial, commercial and financial customers growing strongly during the quarter. Added to a hardening rate environment, this has driven strong growth in premium values. This contrasts with investment returns, which were much weaker than expected during the quarter. The value of claims fell, somewhat unexpected given recent flooding and the general shift towards a more litigious culture among policyholders. In terms of expenses, general insurers appear to have added staff and costs with every new policy written – which may be explained by weak IT systems. As a result, total operating costs and costs per transaction rose during the period. On balance, all of these factors combined to deliver marked increases in profitability for the sector.

Looking at the spending plans of respondents, the survey results point to some weaknesses in the infrastructure of general insurers. Following a period of consolidation, when insurers focused on integration, the sector is now planning more expenditure on IT, with a focus on replacement (a balance statistic of +81% is the highest in five years). Euro-related spending is also re-emerging as an area for investment. Going forward, domestic competition is cited as by far the dominant concern, although systems capacity is also a worry.

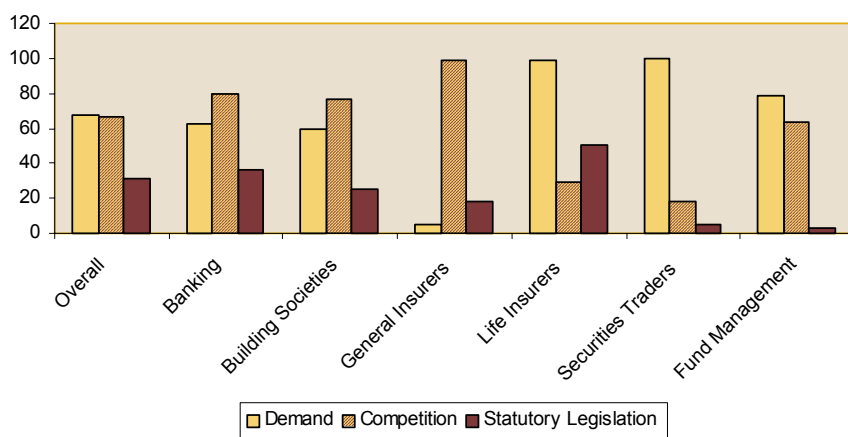
The **life insurance** sector reported a positive swing in business confidence during the quarter, with a balance statistic of +24% of respondents optimistic for the first time in almost two years. Given the extremely poor investment returns of recent quarters, the increase in volumes of business reported by respondents appears surprising. Life insurers controlled their expenses more successfully than general insurers. This can be explained by the cuts in commissions paid to brokers, by falling levels of new contracts surrendered, and by a continued investment aimed at keeping headcount low. Reductions in staffing have continued, with several life companies turning to outsourcing as they adapt to the 'new world' of stakeholder pensions.

As in the general insurance sector, life companies plan to invest in IT. A balance statistic of +99% of respondents expect to boost capital expenditure, with all citing the need to improve efficiency as the prime objective. Looking forward, life companies are worried about their future prospects, which calls into question the positive swing in confidence. Concerns over statutory legislation remain high, and worries about systems adequacy have grown dramatically. But the greatest fear is over levels of demand, as the sector asks itself what can be done to attract new customers, especially as falling equity markets are generating increased media attention to questions of solvency among life insurers.

A balance statistic of -29% of **securities traders** do not feel optimistic about their business situation. After two quarters of optimism in the face of worsening results, expectations appear to have met up with reality. Since respondents see their activity levels as well below normal, and expect still lower volumes of business in the coming quarter, this is hardly surprising. Volumes among commercial customers were unexpectedly higher during the quarter, possibly due to IPOs, which although at low levels, were approximately double the value of the previous quarter. Business across other segments disappointed traders, although sell-offs in the market may have boosted transaction levels since the survey was conducted. Despite having managed their costs downward during the quarter, overall falling levels of business resulted in the sector reporting reduced profitability for the seventh quarter running.

Turning to the future, traders are scarcely encouraged by the prospects for their business. Staffing cuts are forecast for the coming quarter, in addition to the headcount reductions of the current period. Modest increases in training expenditure are expected, but this is probably due to regulatory requirements rather than any efficiency improvements. Investment levels are forecast to fall across all areas, with uncertainty over business prospects cited as the most common reason for caution. As in prior quarters, level of demand is the greatest cause of concern for the future, with 100% of respondents citing it as the main factor limiting the growth of their business.

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



The **fund management** sector reported a modest fall in sentiment during the quarter, with a balance statistic of -4% not feeling optimistic about their business situation. After two quarters of optimism, fund managers are feeling somewhat less confident – although they reported slightly more business than predicted during the quarter. The sector has had a slightly better ISA season than it had been expecting, although responses indicate that volume growth was driven by industrial, commercial and financial customers rather than private individuals. The volume increases reported seem surprising, given the backdrop of depressed markets. Considering the sensitivity of management fees to market performance, for some time fund managers have been cutting costs, and they achieved more during the quarter. Headcount increased slightly, stemming from the need to meet compliance and regulatory

requirements at a time when staff numbers are being heavily reduced elsewhere.

Fund managers' views of their prospects appear mixed. Marketing expenditure is expected to increase, reflecting the expectation that consumers will continue to invest and save, albeit at relatively low levels. And for the first time in over a year, a positive balance of respondents expect IT investment to increase, with the desire for improved efficiency cited as the major motivation for investment. Concerns over levels of demand and domestic competition are stated as the factors most likely to limit business growth.

## New Economy: e-business section

The survey results show a continuing growth in the value of financial services business transacted over the Internet. It is also notable that respondents appear to be improving their ability to forecast and measure e-business volumes – over the last few quarters, their predictions have become increasingly accurate.

One third (33%) of respondents are now transacting more than 10% of their customer business on the web, double the level of the last quarter. In contrast, only 12% of respondents transact more than 10% of supply chain business over the Internet.

Barriers to e-business have not changed significantly since the last quarter. Lack of understanding among customers and suppliers is cited by 62% of respondents as the greatest obstacle to online success, as financial institutions wait for users to catch up with the infrastructure they have developed. Security remains the second greatest concern (32%), and the speed of online transactions is the other significant barrier to development (25%).

Given the current economic climate, it is not surprising to find that web-enabling and extending current business activities remain the two preferred strategic options for growth among respondents. Collaborative alliances remain an avenue of growth for some, but start-ups and 'greenfield' operations have come to a complete halt.

In conclusion, the Internet is increasingly established as a significant channel for financial services companies, but it is far from being the dominant medium that many were predicting a couple of years ago. The take-up of online services is expected to continue, but is unlikely to grow significantly faster than the e-literate population within the wider economy.

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## About this survey

The survey was carried out between 27 May and 12 June 2002. A total of 122 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.

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