

## CBI/PricewaterhouseCoopers Survey

June 2004

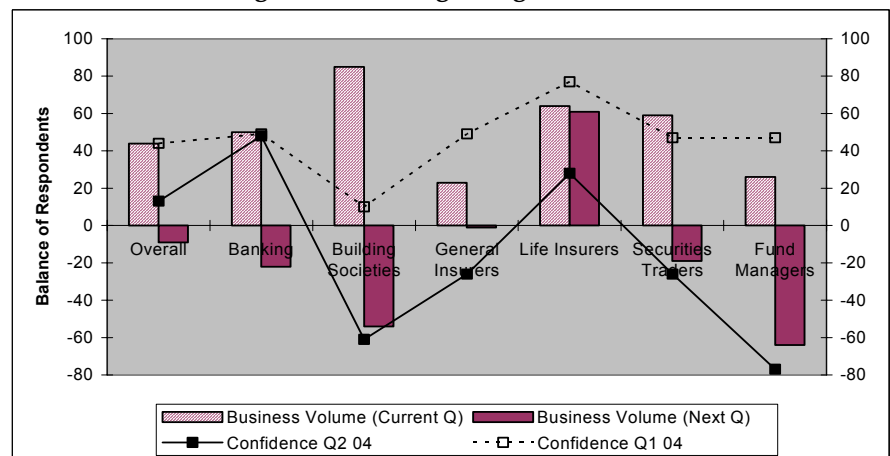
***“Overall confidence was slightly higher than in the previous quarter, even if the headline results conceal some surprising contrasts”***

The 59<sup>th</sup> CBI / PricewaterhouseCoopers financial services survey shows the industry continuing to experience a recovery. Overall confidence was slightly higher than in the previous quarter, even if the headline results conceal some surprising contrasts. For instance, despite the overall improvement in optimism, four key sectors felt less confident than in the prior period. Another contrast was in the area of business volumes. Although all major sectors reported strong increases in activity, several are forecasting a return to negative growth; a sceptical outlook which seems at odds with the relatively benign operating environment. These swings in mood suggest that the industry is still struggling to predict future trends, despite the ongoing recovery in business.

Respondents saw their expense bases climb slightly during the quarter, although strong volumes were sufficient to keep per-transaction costs under control and deliver improved profitability. A key factor driving cost inflation was the increase in hiring reported by most sectors. This, coupled with plans for greater marketing expenditure, is a positive sign which tends to question the pessimism of some respondents.

In terms of investment, capital expenditure plans for IT have reached their highest level in four years. Although some sectors are investing in new products to counteract weakening demand, most are motivated by efficiency goals and regulatory requirements. Looking forward, competition remains the chief preoccupation of respondents. Surprisingly, concerns about legislation and regulation appear to have receded slightly, despite new regulation of mortgages and general insurance, the impact of realistic capital calculations on life companies, and other areas of heightened regulatory interest.

**Figure 1: “Although all major sectors reported strong increases in activity, several are forecasting a return to negative growth”**



A balance statistic of +48% of **banking** respondents felt more optimistic during the quarter, indicating a steady improvement in confidence. Volumes of business and the value of income were both reported to have increased as the banks enjoyed another strong quarter. However, these positive trends are expected to reverse; a balance statistic of -22% expect volumes of business to fall in the coming period. This negative prediction is the most downbeat in a decade and looks particularly surprising given that forecasts for key customer categories remain positive. Although there are some indications in the market that consumer credit demand may be easing, there appears to be little evidence to support this gloomy outlook. Furthermore, the banks are increasingly upbeat about demand from industrial and commercial customers, indicating confidence in the UK manufacturing and services economy. Expectations of growth in average spreads also show that the sector expects to benefit from rising interest rates.

On the costs side, banks' overall and per-transaction operating costs remain well controlled. The value of non-performing loans was also reported to have fallen by a balance statistic of -50%, suggesting that interest rate rises are not yet creating serious problems for borrowers. These benign results underpinned a strong reported increase in profitability, which is expected to continue. Confidence also shows in banks' hiring intentions: Headcount rose, with most additional staff going into customer-facing roles as the sector focuses on relationships. Higher training costs are chiefly attributable to the advent of general insurance and mortgage regulation. In reviewing their spending plans, the banks provide further evidence of optimism; marketing spend and IT investment are both predicted to grow by the largest number of respondents for four years. Furthermore, banks' capital expenditure is increasingly focused on providing new services and expanding capacity.

**Building societies** suffered a renewed swing in sentiment during the quarter, with a balance statistic of -61% feeling less optimistic. After two quarters of slowly increasing confidence, the sector once again appears highly concerned about the prospects for the UK mortgage market. Despite experiencing growth in business volumes and all types of income, activity forecasts are strongly negative. Although a steep fall in house prices is not anticipated, concerns over commission income and business with private individuals suggest that a cooling market is expected to slow deal-flow dramatically. In contrast to the banks, the societies also expect spreads to remain under pressure, as the effects of competition and back-book re-pricing negate the impact of higher interest rates.

Considering this negative outlook, it is surprising to find that the sector expects current levels of expense inflation to persist. Cost growth continues to be driven by increases in headcount and training expenses, as respondents process the backlog of business built up over recent periods. Higher training costs also reflect the introduction of mortgage regulation. Another notable result is in the area of non-performing loans, which are expected to grow by a balance statistic of +30%, the highest level since 1992. Given the low level of arrears in absolute terms this is not a huge worry, but implies that higher interest rates are already affecting the most highly-g geared borrowers. On the investment side, the sector shows its caution, with the balance of respondents expecting to reduce capital expenditure in the coming year. For those that do plan to spend more, improving efficiency and meeting regulatory requirements are among the key reasons to invest.

Sentiment among **general insurers** has reversed during the quarter, with a balance statistic of -26% feeling less optimistic. This mood change reflects an impression that the sector is coming off the top of its current cycle. Volumes of business increased during the period, but the value of commissions fell – a confirmation of market sentiment that rates have peaked, especially in commercial lines. Business with private individuals also disappointed, and is expected to slow in the next

quarter. However, this could be seen as a reversion to normalised growth, given the unexpectedly bullish forecasts of the prior quarter.

General insurers reported increasing cost levels on a total and per-transaction level, trends which are expected to continue. Widespread increases in headcount and training costs were contributory factors, both of which are also expected to persist. Although the value of claims was reported to have fallen by a balance statistic of -49%, this positive news is not forecast to continue. The reduction in rates and the growth in expenses mean that the profitability increase of the current quarter is expected to halt going forward. On the spending front, the sector is becoming more consistent, with IT investment expected to rise for the third successive quarter. However, the slowing cycle means that the reasons for investment are primarily defensive, with the focus on efficiency, replacement and regulation.

The **life insurance** sector maintains its recent run of optimism, with a balance statistic of +28% feeling more positive. Volumes appear to be growing strongly once more; premium income and new business were reported to have expanded, a trend forecast to continue. Although respondents still feel that their overall level of activity is less than they would expect, business with industrial companies and private individuals – the sector's main customers – has reached its highest levels since 2001. Less positively, the value of contracts surrendered within the first two years is now reported to have grown by a balance statistic of +58%. This is the highest level recorded by the survey, and could be attributable to customers cashing in policies in response to higher interest rates.

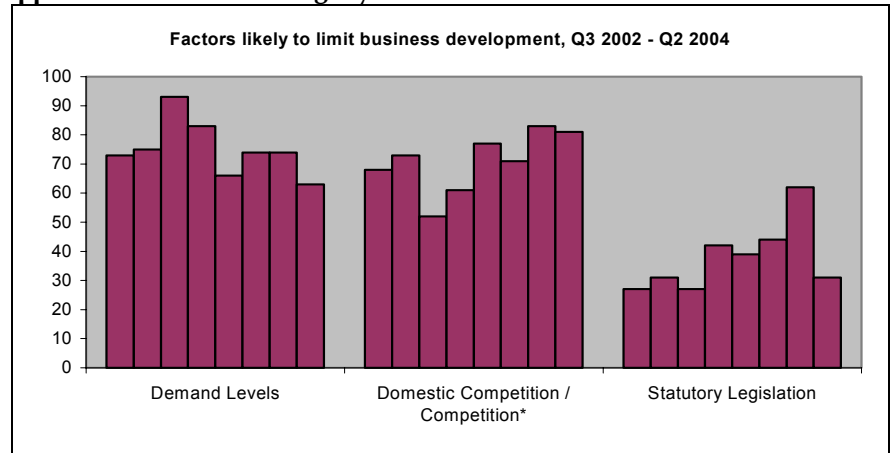
Life companies continue to control costs tightly, and are the only group to have reduced headcount or to be planning further staff cuts. This caution points to the sector's push for efficiency, and in particular to the increased outsourcing and offshoring of processing functions. The drive to reduce costs is also reflected in investment intentions, with the need to increase efficiency a motivation for 94% of those planning to spend more on IT. Regulation is also a factor as the sector prepares for realistic calculation of capital adequacy; although it is yet to be seen if this investment will generate a worthwhile return in economic as well as regulatory capital terms. Despite the effects of Sandler and the anticipation of the Sykes review, the sector sees regulation as less of a limiting factor on business development than for some quarters. This is a surprising finding, but underlines the impression that Life companies are improving their relationships with government and the FSA.

A balance statistic of -26% of **securities traders** reported feeling less optimistic, reversing four consecutive quarters of improved sentiment. Compared to the first quarter of the year, when the sector enjoyed strongly positive results, performance was more mixed. Volumes of business continued to increase, but the rate of growth slowed as traders felt the effects of lower stock market volumes. Traders are expecting a quiet summer, with commission income and trading levels expected to fall. This reflects expectations that weaker demand from fund managers and disappointing business in the advisory and primary areas will keep equity markets flat. Business with private individuals, seen as having grown by a balance statistic of just +10% during the quarter, is also expected to decline, suggesting that some of the sector's earlier bullishness was not firmly related in reality.

Securities traders continue to preside over a rising cost base. Total expenses remain on an upward trend, which is expected to erode profitability in the next quarter as lower volumes begin to bite. Traders continue to hire more staff in a delayed reaction to headcount cuts made during the downturn. The reappearance of guaranteed bonuses for some is unlikely to have caused the increased scale of staff expenses; rising training costs are probably the major driver, as the sector responds to regulatory needs and seeks to broaden its range of products. Despite the pessimistic outlook, investment in IT is expected to grow, with an increasing focus on developing new products and services. Considering the impact of the Financial

Services Action Plan and other regulation aimed at the securities industry, a slight easing of concerns in this area is unexpected.

**Figure 2: “Looking forward, competition remains the chief preoccupation of respondents. Surprisingly, concerns about legislation and regulation appear to have receded slightly”**



\* Change from 'Domestic Competition' to 'Competition' reflects altered survey format in Q1 2004

**Fund management** respondents reported a surprising collapse in confidence, with a balance statistic of -77% feeling less optimistic. Despite a quarter of increased business and higher income, fund managers are forecasting a decline in volumes and commissions, with business expected to reduce across every category of customer. Given the relative steadiness of equity markets, and the fact that investigations in the UK and Europe have found no evidence of significant late trading or market timing, this pessimism looks like an over-reaction. The most likely explanation of the fall in confidence may be concerns about rising interest rates, and their impact on equity values and the savings behaviour of customers. Another factor could be the tendency of sophisticated investors to polarise their holdings into tracker-type products on one hand and high alpha products on the other, with hedge funds an area of particular current interest. However, even allowing for this squeeze on traditional 'active' funds, it is hard to believe that the sector's fundamental outlook justifies such pessimism.

The recent stability of the markets has encouraged fund managers to allow costs to increase. The desire to develop new products is a driver of rapid staff growth, as the sector attempts to increase the sophistication of its client offering. In the current quarter, this was insufficient to erode profitability, but a balance statistic of -73% predict a future reduction in profit margin. Further investment in IT is anticipated by a modest balance statistic of +18%, with most respondents citing defensive reasons for the expenditure. Despite a more aggressive approach to the sector by the FSA, and the disruption caused by recent investigations into trading practices, concerns over legislation and regulation remain measured. Levels of demand are of greater concern, underlining the sector's pessimistic forecasts.

## e-business section

The survey shows that growth in financial services e-business is continuing steadily, if not spectacularly. The level of Internet adoption by financial services customers continues to climb, with those already using the channel the most likely group to pursue further adoption. Otherwise, penetration of financial services companies' total customer bases remains slow, without any decisive leap forward from recent levels.

In reviewing the factors seen as barriers to the development of e-business, the picture that emerges is also consistent with recent surveys. Customer behaviour and preconceptions appear to be the biggest problems, with concerns over data protection, dissatisfaction over Internet speed and preferences for alternative channels being the predominant factors. Most companies in the industry see their e-business offerings as inherently secure, but customers either disagree or would prefer not to take the risk. Following the first quarter of 2004, when valid network traffic was slowed by several well-publicised viruses and worms, customer concerns over Internet speed were reported to have fallen. However, this looks more like a normalisation than a genuine decline.

There has been little change in the strategies adopted for e-business development, although the percentage of respondents planning to web-enable current activities fell to 63%, the lowest level in two years. This does not herald a major shift to alternative strategies, only that some respondents feel that their e-business construction phase has run its course. All that remains now is to wait for a change in customer behaviour.

## Financial Services Survey

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

PricewaterhouseCoopers ([www.pwc.com](http://www.pwc.com)) provides industry-focused assurance, tax and advisory services for public and private clients. More than 120,000 people in 139 countries connect their thinking, experience and solutions to build public trust and enhance value for clients and their stakeholders.

(Unless otherwise indicated, "PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP, a limited liability partnership in the United Kingdom. PricewaterhouseCoopers LLP is a member firm of PricewaterhouseCoopers International Limited.)

### About this survey

The survey was carried out between 26<sup>th</sup> May and 9<sup>th</sup> June 2004. A total of 90 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 [pubsales@cbi.org.uk](mailto:pubsales@cbi.org.uk). The price for a single quarter for members is £46 and for non-members £83; an annual subscription for members £180 and for non-members is £325.

For further information about this bulletin, please contact Elaine Hobson, PricewaterhouseCoopers on 020 7213 4129.

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

Simon Jeffreys

### Insurance

Clare Thompson

This bulletin is produced by experts in their 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.