

CBI/PricewaterhouseCoopers Survey

June 2005

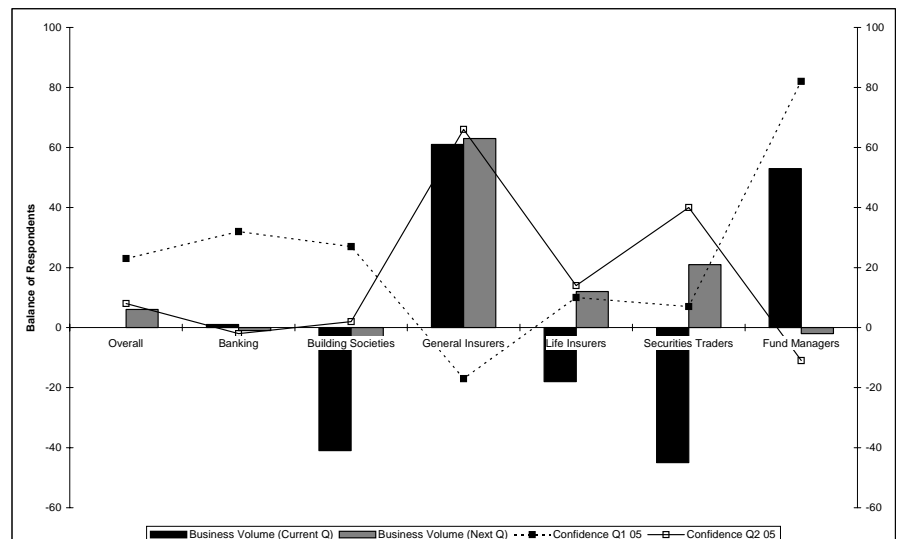
“The industry is pausing for breath... this steady picture contrasts favourably with the falling confidence reported by the latest CBI consumer services survey”

The 63rd CBI/PricewaterhouseCoopers financial services survey suggests that the industry is pausing for breath after a strong up-tick in confidence in the previous quarter. The growth that was forecast at the last survey did not materialise for all sectors, but the industry maintains an outlook of cautious optimism, based upon an expectation of recovery in income streams for most sectors. This balanced view conceals some variations; although most sectors have not changed their outlook notably, securities traders and general insurers inject a note of optimism. Though undramatic, this steady picture contrasts favourably with the falling confidence recorded by the latest CBI consumer services survey.

The industry continues to manage its costs carefully, even if there is a contrast between more cost focused sectors such as banking or securities trading, and the insurance and fund management areas where expenses are being allowed to grow. Overall expense levels are expected to climb slightly in the coming period, with last quarter’s recovery in hiring predicted to continue by most major sectors.

Respondents plan to grow capital expenditure, with increasing numbers expecting to spend more on IT and physical infrastructure. The need for replacement and greater efficiency are now the dominant motivations for investment; regulation is a decreasing factor for some sectors, but remains a priority for others such as securities traders and the insurers. Regulation also remains a major limitation on business development, along with levels of demand and the effects of competition. Life insurers in particular will be impacted by the approach of new pension regulation on ‘A’ day.

Figure 1: “Although most sectors have not changed their outlook notably, securities traders and general insurers inject a note of optimism”



A balance statistic of -2% of **banking** respondents feel less optimistic, a more balanced result after the previous quarter's jump in confidence. Volumes of business and the value of income are reported to have been flat, but a balance statistic of +62% say that the rise in business with private individuals predicted at the last quarter actually came through. This buoyancy in retail demand is surprising given the slight slowdown in UK personal lending growth. One explanation may be that demand for savings products is remaining strong among consumers still wary of returning to the stock market, although recent rises may help address this caution. Downward pressure on spreads continues, but it is notable that commission income is forecast to grow. This implies that the banks are confident of substituting fees for spread income.

On the cost side, responses suggest that the banks have continued to reduce their expense base. This is being achieved in the face of growing headcount, although growth in hiring is expected to level off in the coming period. Significantly, the value of non-performing loans is reported to have stabilised after four quarters in decline. As several banks announced in their trading statements, lower corporate provisioning is offsetting the growth in personal lending arrears. Despite the reduction in costs, profitability is reported to have fallen by a balance statistic of -30%. In terms of capital expenditure, the banks are concentrating on growth; they report a fourth consecutive quarter of investment in branches. Coupled with higher training spend, this points to a focus on customer handling and compliance with sales regulation. In contrast, IT spending is expected to remain flat.

Building societies report a steadier outlook, with a balance statistic of +2% feeling more optimistic after the prior quarter's figure of +27%. The survey results show a real disconnection between the weaker levels of business reported by a huge majority, and the stronger levels of fee income reported by a balance statistic of +68%. This result is surprising in the context of a slowing housing market, and is particularly hard to interpret since half of respondents report less business with the all-important retail segment. The sector's cautious outlook is underlined by its predictions for the coming quarter. Volumes of business and the value of income are expected to remain flat, and no customer segment is predicted to generate notable growth.

Despite the first pause in staff recruitment for over six years, the societies have allowed their cost base to expand again after three quarters of cutbacks. Non-performing loans are reported to have grown by more than half of respondents, the weakest ever result. In spite of these cost pressures, a balance statistic of +71% report stronger profitability.

The societies reveal further caution in their response to investment questions. Over 70% continue to invest in branches and IT, but efficiency and replacement are now the most common reasons for this spending. The sector does not seem to be investing for growth; providing new services and reaching new customers both declined steeply as motivations to spend. Respondents also report some changes in their assessment of obstacles to future growth. Now that mortgage regulation is bedded in, concerns about statutory legislation are receding; but the societies are becoming more concerned about the availability of professional staff as they compete for talent with the banks.

General insurers show a renewed sense of optimism. A balance statistic of +66% are more confident about business conditions, and similar balances report higher volumes and premium income, reversing three consecutive quarters of decline. This buoyancy is unexpected, given that rates are widely seen as remaining flat; the explanation may be that the cycle is not turning down as rapidly as many had expected. It is also surprising that the sector reports strong demand from private individuals, and that this demand is predicted to persist. Investment income also grew during the quarter, and the

rise in volumes, premium and investment income helped the sector to report higher profitability. This is another reversal from the prior quarter, and further improvements are expected over the coming three months.

On the expense side, total operating costs have climbed for the second quarter running and are expected to rise further. Higher employment numbers and training expenditure are reported, with further increases in both foreseen. Nonetheless, average operating costs have continued their fall, and further efficiency gains are anticipated. Claims have increased after two consecutive quarters of reduction, an unexpected result given the absence of major claims events in recent months.

General insurers appear to be investing more in IT, with a balance statistic of 90% planning to increase spending over the next twelve months. The main reasons for capital expenditure are to improve efficiency, provide new services and meet new regulatory requirements such as individual capital assessment. The need to support online platforms may also be a factor. Finally, it is interesting to note that a large majority of respondents (88%) believe statutory legislation will limit business expansion in the coming year.

Life insurers are cautiously optimistic with a balance statistic of +14% feeling more confident. Respondents noted a slight decrease in business; however, this may merely be a readjustment after strong results in the first quarter, and volumes are expected to recover. Strain on new business continued, albeit at a lesser level than during the previous three periods, suggesting that insurers have been cutting prices to win more business. Demand was driven by private individuals, and this is predicted to continue. Overall profitability rose, owing to higher premium and investment income, and more profitable business is expected to be written over the next three months.

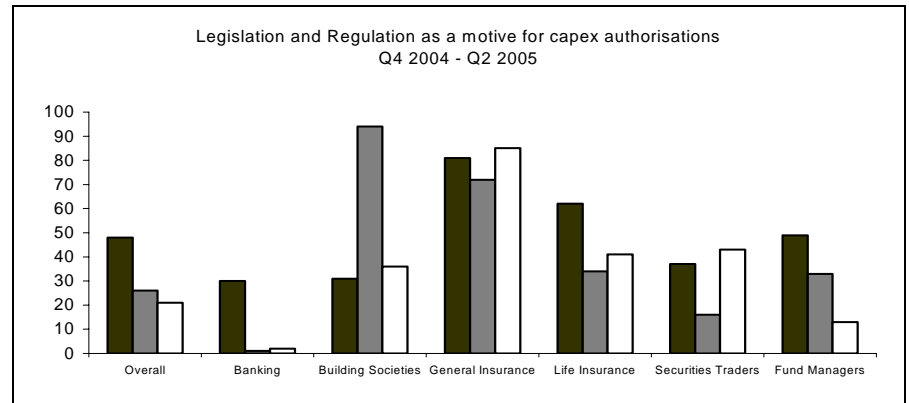
After three consecutive quarters of expense reduction, life companies have allowed their costs to rise. Higher headcount and training expenditure contributed to this and are predicted to expand further in the coming months. However, average operating costs fell and are expected to remain controlled. Turning to capital expenditure, respondents plan to spend more on IT in the coming year, with the need to improve efficiency cited by 87% as life companies replace and upgrade existing systems. In terms of future business development, continuing regulatory developments such as the new pension legislation on 'A day' leads all respondents to view regulation as an obstacle. Uncertainty about demand was also cited by 99% of respondents, illustrating how the sector's current optimism is underpinned with caution.

A balance statistic of +40% of **securities traders** are feeling more optimistic. This is the strongest response for over a year, and looks surprisingly upbeat given the negative responses of traders in other areas. Traders report reduced levels of business, and a balance statistic of -84% experienced lower commission income, implying that falling volumes have been coupled with price erosion. A majority of traders also saw a decline in trading income during the period. Although respondents attribute these disappointing results to soft demand in the retail segment, it seems likely that recent weakness in the hedge fund sector has played a role. Although a modest balance of traders report cost reductions, almost all respondents see profitability as having fallen during the period.

Considering the disappointing operating results reported by the sector, the explanation for traders' confidence must lie in the forecasts they make for the coming quarter. Recent volumes may not have met the high expectations of the first quarter, but the sector is predicting a recovery for later in the current year. A balance statistic of +37% expect commissions to grow, and a majority believe profitability will improve, implying that traders are pinning their hopes on

the early summer IPOs such as Inmarsat, PartyGaming and RHM. In a further indication of confidence, hiring is forecasted to recommence growth. Turning to capital expenditure, a balance statistic of +77% of traders also plan to spend more on IT, the highest figure for seven years. In terms of barriers to future development, traders are becoming more concerned about the availability of professional staff. This obstacle has reached its highest score for some years, which may reflect the sector's struggle to attract suitably qualified staff to embed Basel II, IFRS and Sarbanes-Oxley 404.

Figure 2: "Regulation is a decreasing factor for some sectors, but remains a priority for others"



Respondents in **fund management** report a sharp decline in sentiment, with a balance statistic of -11% feeling less confident. This is in contrast to the large majority who had felt more optimistic in the prior quarter, and is perplexing given the other, positive responses of fund managers. A balance statistic of +53% report higher business volumes and stronger commission income during the period, as the sector benefited from stronger stock market valuations. Other income also expanded, and growth was driven by a broad customer base that included financial companies, private individuals and overseas customers. Although fund managers added to headcount and total operating costs during the period, higher volume was sufficient to offset this, and a balance statistic of +73% report increased profitability. With such positive operating figures, it is hard to understand why the sector is reporting a decline in confidence.

Looking forward, fund managers expect growth to continue in some areas, but level off in others. Income is forecasted to keep growing, although predictions for volumes are flat. Business with financial and overseas customers is anticipated to expand further, but retail activity is expected to fall for the first time in a year. Even so, profitability is anticipated to climb by a modest balance of respondents, and spending plans have a bullish look. The sector expects to accelerate hiring and advertising spend, and a balance statistic of +61% foresee more IT investment, one of the highest levels in recent years. The reasons given for investment also suggest confidence. The need for efficiency was cited by only 41%, the lowest figure for six years, while 63% of respondents now want to expand their capacity.

e-business section

The current survey marks a small milestone in the development of e-business in financial services, with the value of Internet business reported to have grown by a balance statistic of +60%. This is the highest figure since the end of the dot com boom, and is predicted to expand further in the coming quarter. Approximately 15% of financial services customers are now reported to be transacting online. This is an improvement of about 30% over the past year, and almost half of respondents now expect 20% of customers to be active online within a year. Overall, the number and value of financial transactions taking place online appear to be growing more rapidly than at any time in the past four years.

In contrast to this dynamic picture, the major barriers to online development remain relatively static. The two paramount obstacles are still customers' concerns over security and their preference for other channels. Respondents show little confidence that these issues will abate in the coming year, so the challenge of migrating customers online looks likely to persist for the foreseeable future.

More positively, respondents are showing greater signs of seeking strategic solutions to the problems of customer behaviour. The percentage of financial services companies expecting to make collaborative alliances has grown for the second quarter running, reaching a figure of 24%. The difficulty of migrating existing customers online appears to be encouraging companies to seek out new customers who are already Internet users.

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) 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 each of which is a separate and independent legal entity.)

About this survey

The survey was carried out between 25th May and 8th June 2005. A total of 81 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