

CBI/PricewaterhouseCoopers Survey

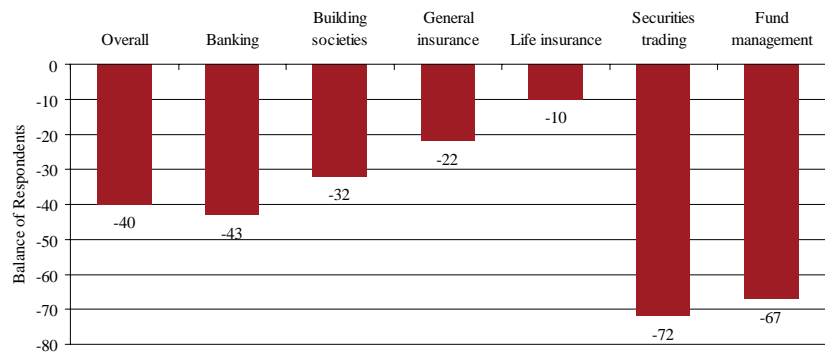
September 2001

“The US terrorist attack came at a fragile moment for confidence in not only the US economy, but also the UK financial services industry”

The 48th CBI / PricewaterhouseCoopers survey was conducted between 28th August and 13th September 2001 and most of the surveys were returned before the terrorist attacks in the US. In spite of this, September’s survey revealed a sharp fall in business confidence and the shock to US business and consumer confidence will almost certainly affect the UK economy. Economists have already shown that the world’s economies are unusually synchronised at present. These results highlight an already deteriorating position, which will have been exacerbated by the terrorist attacks.

Business levels are well below normal and profitability has not improved. Employment has fallen for the first time in almost five years and the level of business is considered to be significantly below normal, and to the greatest extent since December 1997. All the sectors covered by this briefing reported falls in business optimism, with securities traders, fund managers and banks reporting the sharpest falls.

Figure 1 “Overall Financial Services Sector Optimism”



Source: CBI / PricewaterhouseCoopers Financial Services Survey

Having stabilised last quarter, business confidence in the *banking* sector fell dramatically despite a recovery in volumes driven by the retail sector. Business volumes with private individuals grew strongly reporting a balance statistic of + 42%. This is expected to grow more slowly over the next quarter suggesting that banks are becoming nervous about consumer spending, which has been strong. The level of demand has become the most likely constraint on business and, as pointed out earlier in the year, the sector must guard against talking itself into a downturn when many of the underlying indicators are still positive. Overall profitability remained stable and is not expected to change significantly in the next quarter. The value of non-performing loans fell slightly despite expectations of a more substantial reduction.

The findings from the banking sector are a good reflection of the state of the current UK economy. Confidence is weak, but a number of indicators, particularly in the consumer sector, remain favourable. Like the overall economy, consumer spending is strong, but business volumes with industrial and commercial companies, which reflect the manufacturing sector, dropped at the fastest rate since 1992.

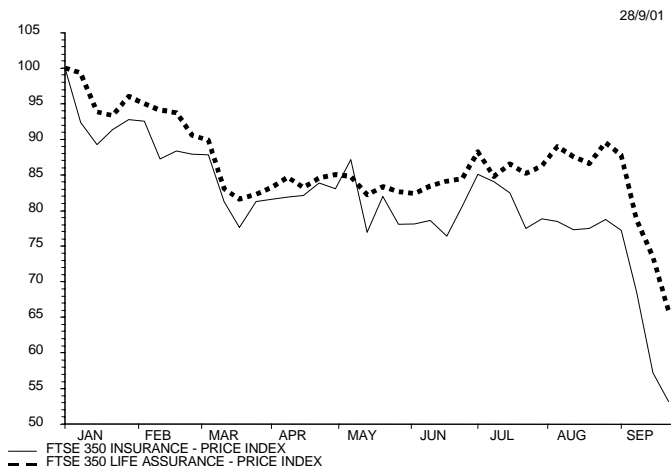
Encouragingly, the banking sector is acting on its perception of the business environment. Employment decreased and total operating costs, after an unexpected increase, fell slightly, addressing the concerns raised in this briefing three months ago that insufficient attention was being paid to costs.

The housing market remains buoyant and the volume of business for the **building society** sector, which continued to grow significantly, reflects this. However, business confidence fell markedly over the third quarter, which reflects fears that the strong housing market cannot continue. Employment is a key indicator for building societies and any signs of a rise in unemployment will affect optimism in this sector. The underlying business continues to perform well and the pressures reflected in this survey appear to come from what respondents read in the papers rather than what they are experiencing in their branches.

As highlighted in the June briefing, the **general insurance** sector continues to display the classic signs that it is nearing a peak in the insurance cycle. Significantly, this was the first quarter for three years to record a negative balance statistic for business confidence, heavily influenced by the retail end of the market. This was despite growth in business volumes, higher than normal levels of business and robust growth in profitability, which is still benefiting from past rate increases. Availability of professional staff, and to a lesser extent, clerical staff, rose in importance as factors likely to limit general insurers' ability to increase business, which is further evidence that the sector is approaching a peak in the insurance cycle.

On the face of it, apart from those directly involved, general insurance will be the sector whose business is most affected by the terrorist attacks, but the very steep fall in share prices, illustrated below in figure 2, is still irrational. Whether insurance companies buckle under the weight of claims will depend on how well the claims have been spread among different insurers and reinsurers. The main threat remains the indirect threat of a downturn in the economy, including the impact on solvency of declining asset values at a time when, using traditional market measures, more capital will be needed to take account of hardening markets.

Figure 2. "FTSE 350 General Insurance and Life Assurance Indices"



Source: Thompson Financial Datastream

For **life insurers**, the overall business situation remains largely unchanged since the June survey, with business optimism recording a moderate fall. A balance statistic of 77% of life insurers said the trend in the value of new business was up over the past quarter. This represented a quarter on quarter change of 89 percentage points and suggests that the life insurance sector is enjoying some success in capturing available savings money. In real terms, the increase in new business cannot yet be explained by the introduction of stakeholder pensions.

Overall profitability rose over the past three months and is expected to continue to rise during the rest of the year. June's briefing outlined the complexity of the problem faced by life insurers who need to cut costs. This quarter's survey revealed that the increase in profitability could have been driven by a fall in total operating costs, which is an encouraging sign that life insurers are starting to get on top of the problem. It is highly likely that the introduction of stakeholder pensions which heralds the "one per cent world", has concentrated industry minds on cost reduction. Statutory regulation barely registered on the consciousness of respondents as a factor likely to limit their ability to increase their level of business over the next 12 months. This was surprising considering N2 is on the horizon and it indicates that the industry may not have recognised the impact of this fully.

A moderate rise in business confidence for **insurance brokers** contrasted with the more pessimistic outlook for the rest of the insurance industry. If rates are coming down and the market is getting more competitive, this sector will also suffer. This sector tends to lag behind general and life insurance in the adoption of new technology, and capital expenditure on IT is expected to rise significantly over the coming 12 months.

Business optimism for *securities traders* fell sharply and expectations in June that the worst is over proved to be spectacularly wrong. The last quarter did not bottom out and as a result confidence has plummeted. The tragic events in America have exacerbated an already downward trend.

Figure 3 "FT 100 Index"

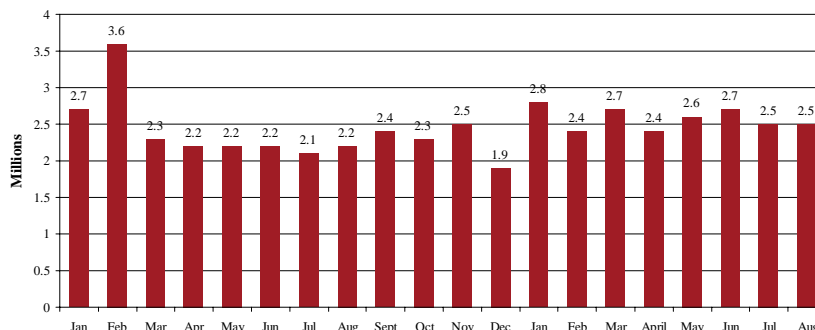


28/9/01

Source: Thompson Financial Datastream

Volumes, which peaked in March / April show no signs of recovery. When interpreting the findings from this survey it is important to try to establish what the normal level of business is. For example, respondents reported that the present level of business is below normal for the fourth successive quarter. The graph below charts the number of bargains on the London Stock Exchange secondary market and shows that the fall in the volume of business is not as dramatic as the surveys suggests.

Figure 4 "UK equity turnover – number of bargains"



Source: London Stock Exchange

Demand is still seen as the key constraint on business expansion, but it is confidence that is critical if the industry is to experience an upturn. The fundamentals are potentially good for securities traders as there is money to be invested, but the question is whether the market's depressed state is holding it back. For example, there are more troubled companies with lower share prices suggesting that there are mergers and acquisitions to be done. With confidence low, deals will tend to increase when shareholders and managers see competitors doing well. This will force them to apply pressure to managers to improve performance and consider corporate activity.

Looking at the statistics in the June survey, increased business optimism for **fund managers** was at odds with falling business volumes and decreasing profitability. Results for the past three months paint a more consistent picture as a fall in business confidence was matched by falls in business volumes and overall profitability. Fund managers will also be

aware of bad corporate news, the threat of a recession and poor results from companies, which will all fuel pessimism in the sector.

On a brighter note, total operating costs fell sharply over the past three months and a similar fall is expected over the next quarter. Fund managers need to attack costs now and this is evidence that they are doing so.

New Economy: e-business section

A balance of 29% of financial services firms reported that the total value of their internet business with both customers and suppliers has increased over the past three months. The banking and, to a lesser extent, general insurance sectors are driving this. This was despite the recent announcement of the closure of the first standalone bank, First-e. A fall in internet business for securities traders is symptomatic of their current business environment and fund managers are finding that fund supermarkets have not been received as favourably as was hoped. The speed of adoption of internet business has been less rapid than predicted, although there are signs that firms' expectations are adjusting to a slower pace of growth than had been expected earlier in the year.

The most cited barrier to e-business development remains a lack of understanding on the part of customers and / or suppliers. The increase in this response is due to a realisation of the obstacles consumers and suppliers face when using internet technology. They have not found internet transactions easy and this is becoming more apparent. In a B2E world, educating employees is easier, but in a B2C environment firms are asking how to educate consumers. The speed at which the internet works is the second most cited barrier to e-business development. A significant proportion of respondents continue to cite the lack of security standards as another significant obstacle.

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About this survey

The survey was carried out between 28 August and 13 September 2001. A total of 133 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. 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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