

CBI/PricewaterhouseCoopers Survey

September 2003

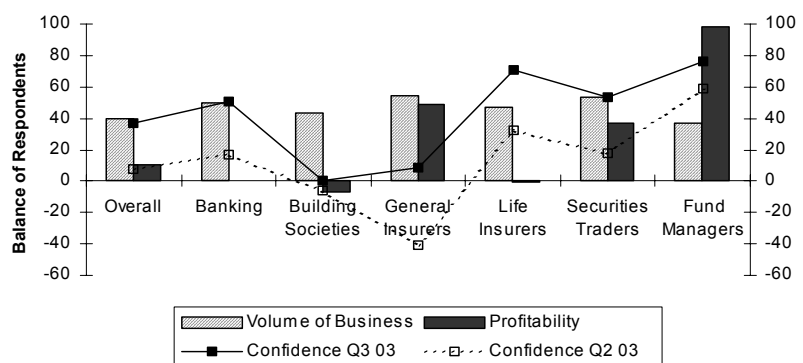
“Overall confidence was the highest since 1999, reflecting better results than many had been expecting, and a remarkable consistency of views across the industry.”

The 56th CBI / PricewaterhouseCoopers financial services survey saw a notable increase in optimism. Overall confidence was the highest since 1999, reflecting better results than many had been expecting, and a remarkable consistency of views across the industry. Most major sectors reported a positive outlook, thanks to a second quarter of equity market appreciation, and the impression that the economic slowdown may be shorter than had been feared. Business volumes grew faster than anticipated, and the apparent return of private individuals to the equities markets was particularly notable. Another pleasant surprise was the increasing value of income, although banks and building societies saw a continuing squeeze on margins.

Total cost levels in the industry remained virtually static, although increased volumes helped to reduce costs per transaction. Despite the continuing plans for expense reduction cited by some sectors, the overall expectation is for a slight increase in costs in the coming period. Nevertheless, there is optimism that recent modest improvements in profitability will continue.

Reviewing the outlook, the picture of an industry growing in confidence is partly undermined by the limited plans for capital expenditure. And while concerns about levels of demand have receded somewhat, competition and statutory legislation remain worrisome for respondents. The recovery of the financial services sector continues, but remains tempered with caution.

Figure 1: “Most major sectors reported a positive outlook, thanks to a second quarter of equity market appreciation, and the impression that the economic slowdown may be shorter than had been feared.”



A balance statistic of +51% of **banking** respondents felt more confident, an improvement on the more cautious optimism of the prior quarter. Business volumes exceeded expectations and are expected to continue growing, with private individuals still the key driver of momentum. Business with industrial and commercial companies stabilised in the current quarter and is expected to expand in the coming period, as banks hope that this sector is now recovering from the slowdown. Despite modest growth in the value of

income, average spreads were reported to have fallen, keeping profitability flat. This tightening, and a planned increase in marketing spend, suggests that competitive pricing pressure remains severe in many areas. Nonetheless, the banks' prediction that spreads will stabilise reflects an expectation that the next move in interest rates will be upward – whenever it comes.

The banks reported static expense levels, suggesting that the cost control programmes of recent periods have by now reached most areas. In fact, previous headcount reductions may explain the balance statistic of +16% planning to add staff to cope with growing volumes, the first positive prediction for jobs in the sector since 2001. Looking forward, the banks identify reasons for their increased optimism; respondents are becoming less concerned about the impact of demand on business development, and do not appear to share the Bank of England's concern over consumer indebtedness. Even so, investment intentions for the coming year remain cautious, with investment intentions flat in the key area of IT.

The **building societies** felt neither more nor less optimistic about their business situation during the quarter, a steady view reflecting results that were largely in line with expectations. The recovery from March's deep pessimism continues, with the societies beginning to believe that a house price crash may not happen. Volume growth returned to the sector with a rebound in consumer demand, probably due to a mixture of equity withdrawal in higher-priced areas, and first time buyers in more affordable areas. Margin attrition and marketing spending are both expected to continue, illustrating the intensity of the ongoing price war with the banks. More positively, the value of non-performing loans continues to fall, as the benign interest rate and employment conditions help borrowers to manage – if not repay – their debt.

On the expenses front, the sector still seems to be struggling with cost levels. Headcount continues to grow and is expected to climb further as an inefficient infrastructure struggles to deal with growing volumes. This inflation, combined with margin pressure, is keeping profitability on a downward track. Looking to the future, there are strong concerns over competition and levels of demand, fuelled by negative press punditry. Given the economic situation, the sector may not fear the credit implications of a house price decline; but any downturn in mortgage demand would rapidly erode profits. The advent of mortgage regulation is also a concern.

A balance statistic of +9% of **general insurers** felt more optimistic during the period, which supports the observation in the last survey that the sector had taken an overly pessimistic view at the beginning of this year. Overall volumes of business appear to have increased well in commercial lines, whilst volumes in personal lines also experienced a small increase that reversed the last two quarters' negative trend. Clearly some pricing power still exists in the sector and the current period's return to optimism would suggest that premium rates, on the whole, remain robust. The trend in the reduction of operating costs, including staff costs, continues amongst the general insurers. However, the longer-term trend of claims inflation has resumed after a short period in 2002 when claims costs were reported to have fallen. Consequently the outlook on profitability is only slightly positive.

Amongst the constraints on insurers' ability to increase levels of business, concern over domestic competition has increased to a relatively high level, whilst worry over demand has remained stable. Surprisingly, concern over regulation fell during the period, despite proposals by the FSA to implement

new capital requirements, and the imminent changes to the regulation of intermediaries.

Optimism in the **life insurance** sector continued to grow with a balance statistic of +71% of life companies feeling more positive; the highest level of confidence in the last twelve months. This is evident in the trend for higher volumes in both group and individual business. In the latter case, however, the overall optimism does not reflect changes in product mix, as sales of with-profits policies are severely down this year while sales of pensions and protection-oriented products seem to have been more buoyant.

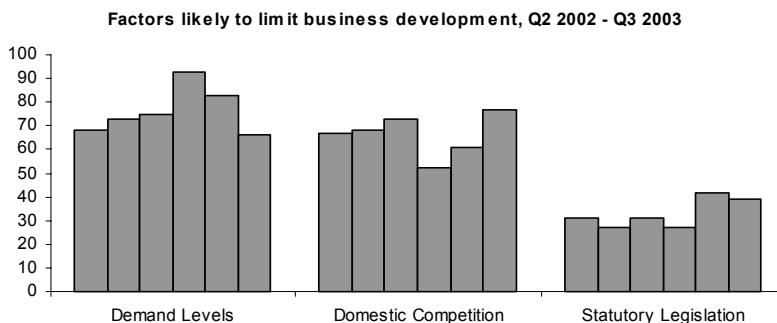
Cost reduction, including staff numbers, continued to be a feature of the sector, and expectations for IT spending also fell to lower levels during the period. However, concern over demand for Life products (which has been very high in the last three quarters) has receded, and is likely to be linked to the recent performance of equities markets. At the same time, concern over domestic competition rose and may reflect a degree of change in the sector, as the withdrawal of certain participants from the market and the increased efforts of newer players affect the competitive landscape.

In contrast, insurance brokers were the only respondents in the survey to register a negative outlook; a balance statistic of -43% of insurance brokers felt less optimistic. This sentiment may reflect some distribution-channel realignment in certain product lines vis-à-vis banks and maybe some non-FS participants such as supermarkets, in addition to significant concern over regulatory developments for brokers.

After a second consecutive quarter of rising equities, a balance statistic of +53% of **securities traders** felt more optimistic. Business volumes were reported to have grown, and a balance statistic of +70% reported increased demand from private individuals – the highest level in over three years. The sector was also successful at converting higher volumes into increased revenues, in contrast to the preceding period, reflecting a better mix of business. The strength of income streams helped traders to report a welcome increase in profits. Cost levels grew slightly, and the sector is planning to grow headcount as it reshuffles staff from research and customer facing roles towards risk management and trading.

Turning to the future, there are further mixed signs from the securities traders. A small majority plan to increase IT spending, but this will be more strongly focused on replacement than before. Concerns about demand have fallen slightly, but the EU Financial Services Action Plan continues to loom large, with statutory legislation cited as a threat by 42% of respondents. These factors, and the modest outlook for profitability, imply that the sector's optimism remains tinged with doubt; many in the markets feel that the rally in equities might not survive an increase in consumer gearing.

Figure 2: “While concerns about levels of demand have receded somewhat, competition and statutory legislation remain worrisome for respondents.”



The **fund management** sector continues to enjoy a turnaround in confidence even more marked than that of the securities traders. A balance statistic of +76% of respondents reported feeling more optimistic as the equity markets rose. Higher prices attracted new investors - business with private individuals increased for the first time since the end of the bull market. Other customer sectors saw growth too, pushing up overall volumes of business. Average commissions also rose, assisted by the popularity of alternative investments offering lucrative asset-based fees. The result was a striking increase in the value of fees and commissions, reported by a balance statistic of +67%. With results like these, some fund managers may be regretting recent capacity reductions, for instance in areas serving high net worth customers.

On the costs side, there was evidence that the sector’s drive for efficiency is delivering results. Total costs fell, and continuing headcount reductions are expected to keep expenses under control. This reduced cost base helped to turn income gains into profits, and the result was the increased profitability reported by a balance statistic of +98%, a remarkable success story. Despite these achievements though, respondents may have cause for concern. The current growth in income is unlikely to profit all managers; the best performers will benefit most, and there is evidence that consolidation in the sector may be accelerating. Nor is there a consensus that markets will continue to climb – levels of demand remain a concern for 85% of respondents. Finally, changes in regulation and accounting standards are forcing fund managers to spend more on training. Like their sell-side counterparts, fund managers may be at risk of further disappointments.

e-business section

The slow expansion in the value of financial services business transacted over the Internet continues, with increasing signs that the industry is becoming more accurate and realistic in its growth expectations. More than half of all businesses surveyed reported that more than 10% of their customers are now using web-based services, with those that do using the channel increasingly. Nonetheless, the majority of customers remain stubbornly un-adoptive, and respondents believe this unwillingness or lack of understanding remains the most critical barrier to future e-business development. Many customers are not yet convinced of the benefits of doing their business online, and the market is beginning to see companies targeting this inertia through discriminatory pricing. Finally, the increased interest in funding start-ups noted last quarter continues, and interest in collaborative alliances has also grown.

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Elaine Hobson
PricewaterhouseCoopers
Southwark Towers
32 London Bridge Street
London SE1 9SY

or send an email to:

elaine.hobson@uk.pwc.com

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About this survey

The survey was carried out between 26 May and 11 June 2003. A total of 107 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. 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.

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

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