

## CBI/PricewaterhouseCoopers Survey

September 2004

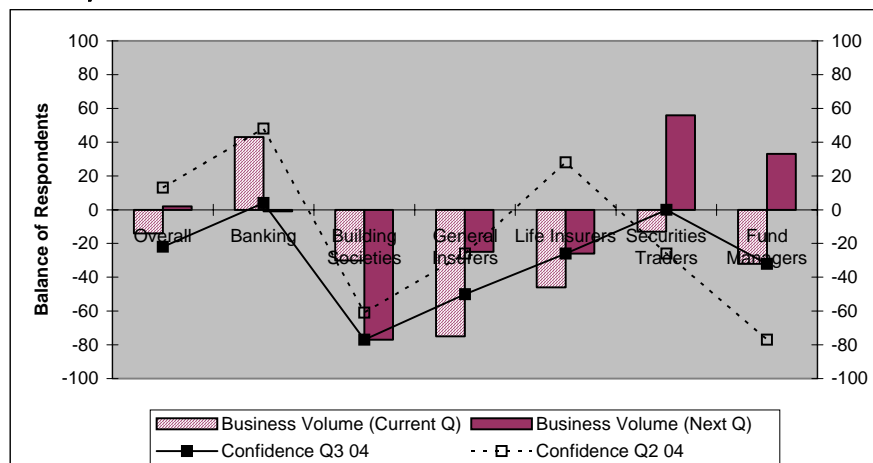
**“The industry’s recovery is not proceeding as smoothly as had been hoped”**

The 60<sup>th</sup> CBI/PricewaterhouseCoopers financial services survey suggests that the industry’s recovery is not proceeding as smoothly as had been hoped. After five quarters of growing confidence, respondents in most sectors reported feeling less optimistic. The key determinant of mood was lower business volumes, with some sectors predicting further falls for the coming period. Although overall expectations for the next quarter are for income levels to stabilise, sentiment varies considerably across the major sectors, and predictions for all customer segments are cautious at best. In particular, demand from private individuals is forecasted to fall across most sectors. Respondents are expecting interest rate rises to influence consumer behaviour, despite the background of economic growth and stabilisation in the financial markets.

Overall expense levels grew, with a corresponding effect on profitability, even though a modest balance of respondents reported reduced headcount during the period. Cost inflation is expected to continue as the industry invests to stimulate future growth, with marketing expenditure in particular shows no signs of slowing.

Respondents are growing more cautious about authorising capital expenditure; the focus is increasingly weighted towards non-discretionary spending, with replacement the primary motivation. Most sectors also see regulation as an increasingly entrenched driver of investment, although banks appear to be a notable exception. Reviewing their outlook for the coming year, respondents identify level of demand as a greater concern than at any time since the end of the bear market.

**Figure 1: “Respondents in most sectors reported feeling less optimistic. The key determinant of mood was lower business volumes”**



A balance statistic of +4% of **banking** respondents felt more optimistic during the quarter. This modest improvement belies the overall results, which point to another highly successful quarter for the banks. Business volumes and non-interest income grew strongly during the quarter, but are expected to level off as consumer credit demand slows. Although a balance statistic of -43% expect to see retail business decline in the next period, the sector remains sanguine. Rising interest rates are by no means all bad news for the banks; even if the consumer boom is drawing to a close, respondents are expecting interest income and investment returns to rise as spreads widen. Non-performing loans remain at minimal levels.

Reflecting their confidence, banks have allowed costs to rise. Following last quarter’s spike in IT investment authorisations, the sector appears to be in a spending phase; 98% of respondents see replacement as a reason to invest, suggesting that system capacity may be a driving factor. Another notable area receiving further investment is land and buildings, which suggests ongoing investment in banks’ branch networks. The result is that expense levels maintain their upward trend, despite flat headcount during the period. Furthermore, respondents indicate that recent staffing expansion has come to an end, with a balance statistic of -39% expecting headcount to fall in the coming quarter.

**Building societies** experienced a further deterioration in sentiment during the quarter, with a balance statistic of -77% feeling less confident. Business volumes were reported to have decreased by a balance statistic of -30%. This was the worst result for ten years, and the sector expects further weakening in deal-flow and income in the coming quarter. This decline, which had been predicted, stemmed from a marked drop-off of business with private individuals and provides further evidence of a housing market slowdown. Unlike the banks, the societies seem unable to benefit from rising interest rates, with fierce

competition keeping average spreads under pressure. A more positive finding is that arrears remain at extremely low levels; however respondents are concerned that the slowdown in the housing market could trigger a rise in non-performing loans.

In response to this weakening picture, the sector reported a reduction in total operating costs for the first time in over two years. This was achieved despite an increase in headcount, although staffing levels are expected to stabilise as societies end their recent run of recruitment. Despite their negative outlook, respondents appear willing to invest in capital projects, with a balance statistic of +22% planning to spend more on IT. The key factors behind this expenditure are cited as the need to improve efficiency and meet the requirements of new regulation. Regulation also emerges as the greatest challenge to the sector's future development, identified by 98% of respondents.

A balance statistic of -50% of **general insurers** feel less upbeat compared to the previous quarter. The mood reflects the widely-held view that the general insurance cycle has peaked. This impression appears to be confirmed by the fall in volumes and premium income reported by a balance statistic of -75% of respondents. More positively, buoyancy in the equity markets and rising interest rates contributed to widened spreads during the quarter. These trends in volumes, income and spreads are all expected to persist into the coming period.

Respondents have seen total and average operating costs rise during the period, and further rises are expected in the next quarter. Claims experience was also higher than in the preceding three months, possibly due to the adverse weather conditions during the late summer. The combination of decreasing volumes and growing costs had the effect of depressing overall profitability, a trend predicted to continue over the remainder of this year. Reflecting this air of uncertainty, general insurers do not expect to authorise more capital expenditure over the next twelve months. There appears to be a shift from discretionary to essential spending, with all respondents citing replacement needs as a driver of investment, and over half prioritising regulatory spending. Looking to the next twelve months, 100% of respondents see uncertain demand levels and competition as factors likely to limit the growth of their business.

A balance statistic of -26% of **life insurance** respondents feel less optimistic about their overall business situation. A balance statistic of -46% report a decline in business volumes, a reversal of the last quarter's two year high, and a downturn expected to continue. Premium income was also reported to have decreased, although a rise is expected for the next period. Competitive pressures are not only squeezing volumes, they are also leading to margin tightening, with the consequence that new business trends are now reported to be negative. These findings mark a backwards step for the sector, and are a surprise

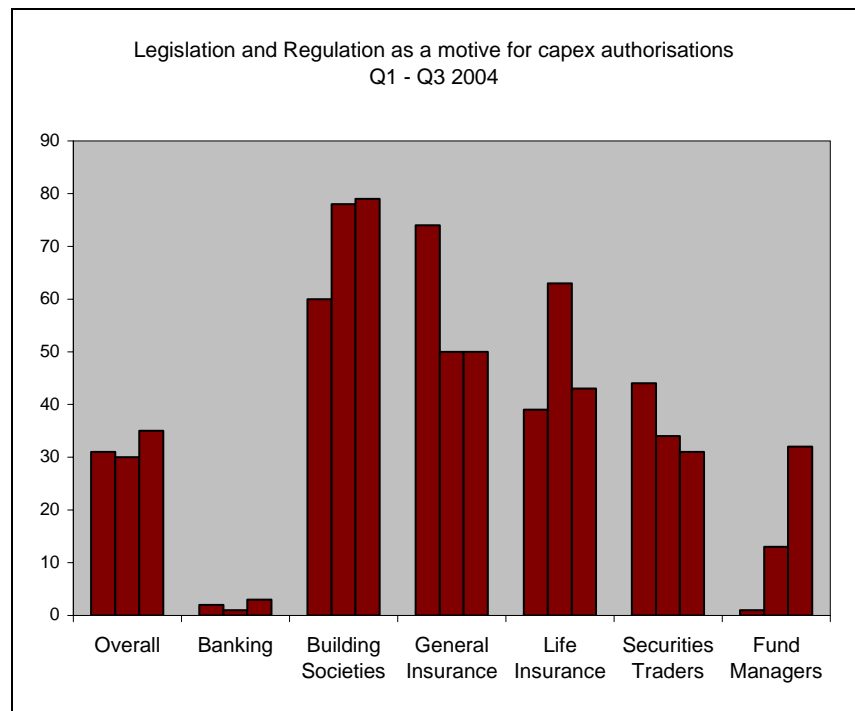
given the upbeat views of some life companies. Many of the large life players were cautiously optimistic in their first half announcements for 2004, reporting a pick-up in pensions business and indications of strengthening UK saving rates.

In contrast to the unexpected pessimism about income flows, the sector's responses in the cost area are less surprising. Headcount and training costs were reported to have declined during the period as life companies continue to announce efficiency-seeking measures. Although respondents are expecting a decline in capital expenditure over the next twelve months, it is notable that 71% cite the drive for efficiency as a motivation for any expenditure. Looking forward, uncertain demand and increasing competition are seen as the major factors limiting business development. Statutory legislation and regulation are also seen as key challenges; life insurers are one of several sectors spending increasing amounts on regulatory compliance (see figure 2). It will be interesting to see how the competitive landscape changes in response to the introduction of depolarisation and the 1.5% cap on Sandler products.

The confidence of **securities traders** remained level during the quarter, although volumes of business and the value of income fell. This represents a partial recovery from last quarter's negative view, and suggests that traders have been trading water during the quiet summer season. Overall, respondents were disappointed by the period's activity levels, but have better expectations for the autumn months, possibly influenced by recent advisory activity. While business volumes and commissions fell during the quarter, they are anticipated to recover; investment income shows a similar pattern, suggesting hopes of an autumn rally in the markets. Expectations for stronger growth from private individuals have also revived, but overseas customers generate the most optimism: a balance statistic of +29% expect business with this segment to grow in the next quarter.

Traders report steady cost levels for the first time in several quarters, even though expenses are expected to resume their upward march, driven by headcount levels and staffing costs. It is surprising then to find that respondents expect profitability to improve going forward; this is another result that suggests traders are pinning their hopes on a recovery in volumes. A further sign of confidence is that capital spending on IT is expected to rise, with the desire to provide new services the most common reason to invest. Nonetheless, despite hopes of a boom traders are more cautious when asked to identify limiting factors on their business. Although concerns over regulation have declined – perhaps a surprise, given recent FSA activity – all respondents say they are concerned about levels of demand.

**Figure 2: “Most sectors also see regulation as an increasingly entrenched driver of investment, although the banks appear to be a notable exception”**



**Fund management** respondents reported another fall in confidence, with a balance statistic of -32% feeling less optimistic. After a surprisingly negative set of results in the previous quarter, fund managers again paint a more gloomy picture than might be expected given the wider picture of steadying markets and positive investment trends. Business volumes and the value of income were reported to have fallen during the period, owing to disappointing business with the sector’s key institutional customers. One possible explanation for these results may be that fund managers responding to the survey are unable to meet institutional demand for alternative investments such as real estate funds. Fund managers are more optimistic about their revenue streams when looking to the future, even if this is contradicted by negative predictions for business with key customer segments.

Expense trends imply that fund managers are making continued investments in their infrastructure, despite falling levels of staffing. Marketing spend is generating upward pressure on costs, as the sector spends more on brand management and development. Regulation is a driver of spending as the sector implements tighter documentation standards for trading records and client information. On balance, the effect of lower income and higher costs was to depress profitability, a trend expected to continue. Even so, survey responses which show a balance statistic of -91% planning to reduce IT investment plans are another surprise; anecdotal evidence suggests that systems are under ever-growing pressure, arising from the need to grow capacity,

maintain efficiency and comply with incremental regulation. Regulation also represents a long-term challenge for the sector; the FSA's consultation on bundled brokerage and soft commissions ensures that concerns in this area remain at record levels.

## e-business section

The volume of financial services business transacted over the Internet is still growing, although the rate of growth appears to have declined slightly compared with previous quarters. Companies are expecting the proportion of their customers who transact over the Internet to increase over the next year, but are not anticipating a massive change. Roughly 9% of the average financial services company's customers currently use its web-based services, a figure expected to rise to approximately 13% next year.

Customer concerns continue to be the main obstacle to faster adoption. On the positive side, customers are more familiar than ever with how to transact on web-sites. Also, their preference for use of other channels, while still significant, appears to be declining. However, there has been a significant rise in customer concerns about security and data protection, probably as a result of the recent spate of 'phishing' attacks and the associated press coverage. These now represent the biggest single barrier to growth.

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### About this survey

The survey was carried out between 25<sup>th</sup> August and 8<sup>th</sup> September 2004. A total of 80 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](mailto:bookshop@cbi.org.uk). The price for a single quarter for members is £55 and for non-members £90; an annual subscription for members £200 and for non-members is £350.

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