

Financial Services Survey

CBI/PricewaterhouseCoopers Survey

September 2002

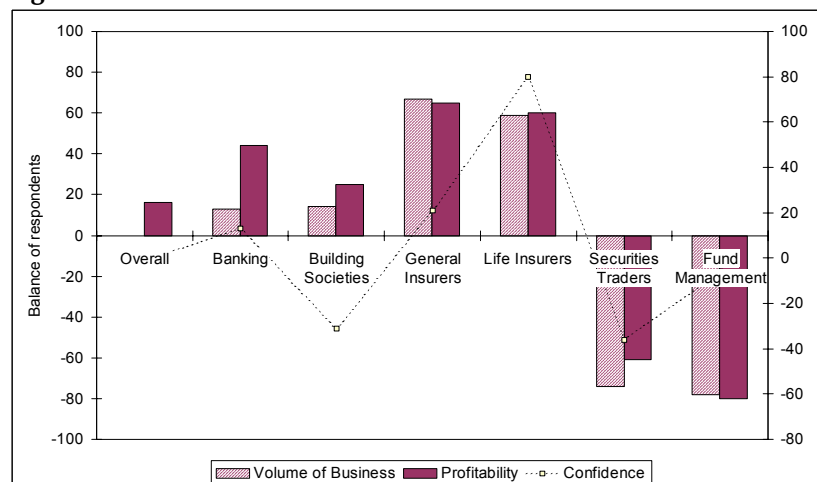
“The more market-sensitive businesses appear to be coming to terms with a more prolonged bear market... Uncertainty remains a key theme for the industry”

The 52nd CBI / PricewaterhouseCoopers financial services survey showed a very slight decrease in overall business optimism. This reflected a picture of flat business volumes over the past three months, disappointing the more optimistic expectations of the previous quarter. Overall, volumes of business with private individuals declined during the period, a trend which is expected to continue. This appears to suggest that the growth levels enjoyed by some sectors in recent quarters could come under pressure. While falling stock market values have emphasised the increasingly close links between different elements of the financial services industry, clear distinctions remain between the sectors.

On the cost side, staff numbers increased slightly, as some sectors sought to take advantage of market growth. Despite this, overall costs were successfully reduced across the industry. It was this improvement in efficiency that lay behind a second consecutive increase in profitability.

Reviewing investment intentions, it is expected that capital expenditure growth will be focused on the IT area, with the emphasis firmly on increasing speed and efficiency. The more market-sensitive businesses appear to be coming to terms with a more prolonged bear market, with no immediate prospect of a recovery. Levels of demand and competition remain the predominant longer-term concerns for all sectors, although statutory legislation and shortage of finance have become increasingly worrying for some. Overall, uncertainty remains a key theme for the industry.

Figure 1: “Clear distinctions remain between the sectors”



Source: CBI/PricewaterhouseCoopers Financial Services Survey – September 2002

N.B. The overall trend in 'volume of business' was a balance statistic of 0%

Among **banking** respondents, a balance statistic of +13% reported increased optimism during the quarter. This suggests that the UK banking sector remains well positioned, a view supported by the generally positive trends reported by respondents. Business with private individuals continued to drive volume growth, aided by ongoing strength in the consumer lending market. Although business with industrial and commercial companies disappointed, the banks are hoping for stronger lending in the coming period, possibly due to less accessible finance from the capital markets. Spread income increased during the quarter, thanks to a benign interest rate environment and a lack of competition from the securities markets. Fees and commissions have also grown, driven by lending fees. These income growth trends are expected to continue, underpinned by stable operating conditions.

The banks appear to have kept non-performing loans under control, with a slight increase being driven by the corporate sector. Costs too appear to be well controlled, with staff numbers falling slightly during the quarter. Staffing levels are expected to fall further in the coming period and capital expenditure plans are restricted to IT, with improving efficiency a greater priority than increasing systems capacity. Furthermore, 62% of respondents cited uncertainty over demand as a limitation on investment, almost double the level in the prior quarter. However, in reviewing their prospects the banks appear generally less concerned about factors limiting the growth of their business than in the previous three months. Despite some concerns, banks seem to be in a stronger overall position than many other sectors, underpinned by a broad spread of businesses.

A balance statistic of -31% of building societies reported a fall in optimism for the quarter, reflecting a mixed outlook for the sector. Overall business volumes have increased but personal sector growth, a driving force in recent quarters, disappointed. There were signs of weakness in the buy-to-let market, and volumes of business with private individuals are expected to decline in the coming period. This impression is reinforced by the most recent Halifax research, which noted a moderation in the growth of house prices. The value of fees and commissions failed to meet expectations, possibly owing to fee-free refinancing mortgages and poor sales of guaranteed equity bonds. Spread income also fell, despite the stable interest rate environment, indicating that price competition remains fierce in the mortgage market. More encouragingly, a balance statistic of -64% reported a fall in the value of non-performing loans. Arrears remained extremely low, due to still-strong employment levels and the low interest rate environment. Despite increased headcount, costs fell during the quarter, helping to support profitability, although this trend is expected to reverse in the coming quarter.

Turning to the future, **building societies** are becoming concerned about levels of demand. Any drop-off in new business, in combination with the gradual re-pricing of back books, could raise serious questions over growth. However, a reduction in interest rates would help mitigate this concern. Other factors also point to a more cautious outlook among the building societies. An intention to increase advertising spending reflects the need to regain market shares lost through price competition, and headcount is expected to decrease. There are also concerns about future business growth; levels of demand and domestic competition are cited as a concern by 97% and 100% of respondents respectively. Statutory legislation has also become a greater concern as the building societies anticipate the introduction of new mortgage regulations.

Overall, while the sector has continued to increase its profitability, there are some signs that the growth levels of recent quarters could be beginning to recede.

General insurance retains its positive outlook, with a balance statistic of +21% of respondents feeling more optimistic. The sector's performance continues to hold up well, driven by strong levels of business. Volume growth is reliant on the industrial, commercial and financial sectors rather than personal lines, although there appear to be doubts as to whether growth can be sustained at current levels into the coming three months. Unsurprisingly, investment income declined for the fifth successive quarter. Costs grew overall as companies sought to exploit the strong market by adding staff, although the effect of greater volumes was to reduce costs per transaction. Reduced growth in commissions paid is consistent with expectations of a slowing market. Profitability increased strongly, assisted by a reduced level of claims. After the prior quarter, when claims decreased for the first time in seven years, this successive reduction is notable. For the first time, the forecast trend is now also negative. The reasons for this are not entirely clear, but may reflect the absence of major UK losses in the last six months, and the increased risks being retained by corporate insureds.

The optimism of general insurers is tempered with caution. Concern about the impact of levels of demand on growth was cited by 79%, a steep increase from the prior quarter. Worries over statutory legislation have also grown. Additionally, respondents are becoming more preoccupied about their ability to finance capital expenditure, reflecting the degree to which falling asset values have eroded the capital base of insurers. However, spending plans show the sector in a more confident light. Investment in IT is expected to grow, and while replacement remains a key reason to invest, 93% say that providing new services is a factor. This, combined with an expected expansion of marketing spending, suggests that general insurers are hoping to counteract any market softening with new growth.

In the **life insurance** sector, a balance statistic of +80% of respondents report feeling more optimistic than in the previous quarter. This may seem a surprising result, given the difficulties facing life companies. Indeed, at first glance several elements of the survey data appear to contain some inconsistency, although this may merely reflect the uncertainty felt within the sector.

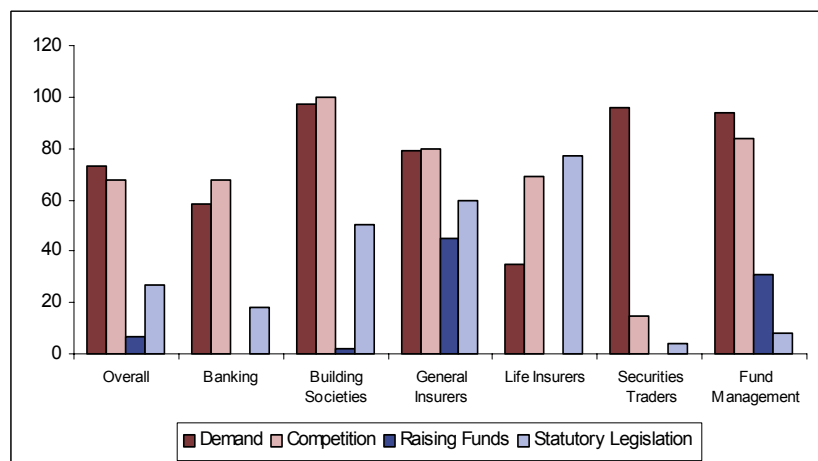
The increase in optimism appears to have been driven by the marked growth in business volumes reported during the quarter. Whilst the absence of any major negative publicity for the sector during the period might explain some increase in business, the magnitude of reported growth is surprising. It appears all the more so, given that a balance statistic of -73% of respondents reported the value of new business to have fallen – a result of the squeeze on new business margins being felt across the sector. Headcount increased rapidly during the quarter, possibly reflecting the continuing sales investigations at some companies. Total costs also rose, and yet profitability was reported to have increased; another surprising result given the recent market downgrading of earnings projections for life insurance companies. On the investment front, life insurers are expecting to increase capital expenditure in the IT area. While the search for efficiency remains the main motivation to spend, expansion of capacity is also a factor. Furthermore, shortage of finance is seen as a limiting factor on investment by 66%. This is the highest level in ten years, and mirrors the squeeze on capital recorded by the general insurers.

Looking forward, the sector sees business growth as likely to be limited by competition and statutory legislation, which returns as a major worry, fuelled by the combination of FSA activity and the Sandler proposals.

Unsurprisingly, **securities traders** reported a further fall in confidence after the negative swing of the prior quarter, with a balance statistic of -36% feeling less optimistic. A large majority (balance statistic of -95%) feel that their level of business is below normal, and volumes are reported to have fallen across all customer segments. These responses mirror sentiment in the industry, which is now anticipating a 'double-dip' bear market. The performance of the financial markets, coupled with weak economic growth projections, also mean that no improvement is forecast in the immediate future. Volume trend expectations remain negative, in contrast to the first quarter of 2002 when hopes of a recovery remained strong. The market's impression is that institutional funds are increasingly moving away from the equities markets and towards other asset classes. This trend is likely to be accelerated by any interest rate cuts, although revived government bond issuance might be a consolation to traders. On the cost side, staffing levels and total costs were reduced during the quarter, although costs per transaction edged up. This may reflect the regulatory burden on the sector, which continues to grow. However, cost control was not enough to prevent a fall in profitability being reported for the eighth consecutive quarter.

Securities traders still appear predominantly pessimistic about the outlook for their sector. Despite intending to cut costs further, the expectation is that negative volume trends will continue to depress profitability. Investment in the coming year is forecast to be less than in the prior twelve months, with uncertainty about demand and business prospects cited as the key limiting factor. Of the factors likely to limit business growth, level of demand again remains the dominant theme, identified by 96% of respondents. All in all, while securities traders remain distinctly negative about their prospects, there is no indication in the survey results that serious long-term structural changes are being considered.

Figure 2: Factors cited as likely to limit respondents' ability to increase levels of business over the next twelve months



Source: CBI/PricewaterhouseCoopers Financial Services Survey – September 2002

A balance statistic of -6% of respondents in the **fund management** sector felt less optimistic about their situation during the quarter. The prior quarter's modest hopes of increased business volumes did not materialise, and the value of all types of income was depressed by falling markets.

Business fell across most customer segments, although there was some cause for optimism - respondents are expecting to increase their business with overseas customers.

This may reflect hopes that European distribution channels are opening up to UK-managed products. Fund managers may also take comfort from reduced levels of costs. This has been achieved largely through outsourcing, indicated by reductions in staff numbers – a trend expected to continue. However, overall profitability declined during the period.

Looking forward, fund managers have comparable concerns to their sell-side counterparts, the securities traders. Level of demand is the factor most likely to limit business growth, but competition is also an issue. A balance statistic of +31% also stated that raising funds was becoming a concern, the highest level in over ten years. This is explained by several factors, including conflicting demands for capital, the expected need to reinvest in IT after extensive cost reduction and the potential additional capital requirements of Basel II in the future. Capital rationing by parent companies of fund managers may also be a factor. Respondents remain cautious, expecting to authorise less capital expenditure in the coming period than in the last, again citing uncertainty over demand and business prospects as the key limiting factors.

New Economy: e-business section

The results of the e-business section of the survey once again show a continuing growth in the value of financial services business transacted over the Internet. However, an increasing number of respondents are finding that the growth rates of e-business are not meeting the levels they had hoped for. This seems to contrast with recent periods, when growth rates were more in line with expectations.

There has been a notable change in the preferred strategic paths to growth identified by respondents. While web-enabling and extending current business activities remain the most popular options for growth, launching new ventures through collaborative alliances has grown more popular. This strategy is being adopted by 38% of respondents, the highest level since the introduction of the New Economy section of the survey. This reflects the growing popularity of joint ventures in the marketplace, as demonstrated by some recent product launches. In this context, it is interesting to note that the ability to form and manage alliances is seen by respondents as a rising barrier to future e-business development.

The major barriers to e-business remain fundamentally unchanged, but concerns about these barriers appear to be increasing rather than reducing. Lack of understanding among customers and suppliers is cited as an obstacle to success by 64% of respondents, with security (33%), the speed of the internet (34%) and the speed of web service platform development (27%) all seen as more problematic than in the prior quarter.

Overall, while the Internet is now an established business channel for financial services companies, e-business investment appears to have reached a hiatus. In the current environment, IT expenditure is focused less on customers and more on the search for back office efficiency. The expected pace of e-business growth appears to be slowing as the barriers to further development start to look less easily overcome than previously thought.

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About this survey

The survey was carried out between 27 August and 11 September 2002. A total of 122 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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