

CBI/PricewaterhouseCoopers Survey

December 2000

“A slowdown in growth and a return to normal levels of business presents a new challenge for financial services at the start of 2001”

Business confidence remains stable and 2000 finished with a return to normal levels of business, as opposed to the fast rates of growth and activity experienced earlier in the year. Economic fundamentals remain good and growth is expected to continue in the first three months of 2001, although sectors which increased capacity and costs in anticipation of continued fast growth, will face a period of adjustment. In the 45th Confederation of British Industry / PricewaterhouseCoopers quarterly survey general insurers reported the sharpest rise in confidence, while fund managers, who have increased costs and capacity, reported the most significant decline in confidence. Eighty four per cent of fund managers said one of the main reasons for capital expenditure was to expand capacity and this has featured strongly for the last five quarters. The key to success at the start of the year is to manage costs at a time when business growth is slowing down.

In the **banking** sector, our surprise at the collapse in confidence in the previous quarter was justified and results in this quarter showed that the downturn was a blip. Business confidence is stable and the volume of business increased strongly, despite expectations that it would fall. The trend in business volumes with regard to private individuals rose strongly during the fourth quarter, showing that the fundamentals of the UK economy are still good. Volumes are expected to increase more moderately in 2001 reflecting the economic outlook. The personal banking sector is a bellwether for the economy and consumer lending and mortgages are the two main drivers. The Halifax expects gross lending to remain broadly flat in 2001, at around £116bn and growth in consumer credit is expected to slow. Many commentators believe that interest rates have peaked and expect the MPC to cut rates in 2001. This has obvious implications for average spreads and 60% of banks expect these to fall over the next three months.

Sixty one per cent of banks expect to authorise less capital expenditure on IT over the next twelve months. This is a dramatic quarter on quarter fall and for the first time since September 1998, the number of respondents who expect to reduce capital expenditure on IT is greater than the number expecting to increase expenditure. Internet launches have slowed down and the sector appears to be scaling back the roll out of new systems. IT spending, which was deferred in 1999 to accommodate the millennium bug, will have accounted for a large amount of IT spend during the year and the signs are that the sector has now caught up. Despite the current strength of the UK economy, the slow down in the US economy will influence retail bankers who are worried about the long term impact on the UK. IT spending, which by its very nature is long term, will reflect these concerns.

Business confidence fell slightly in the **building society** sector. Like the banking sector, an expected fall in business volumes did not materialise and respondents reported a small increase in volumes. In common with the banks, and indeed many of the other sectors covered, training expenditure is expected to increase over the next three months, a probable sign that building societies are gearing up for N2 in the second half of 2001. This is the date when the Financial Services and Markets Act (2000) is implemented

and the FSA's new regulatory regime for financial services in the UK comes into effect. Its rules for training and competence will extend to banks and building societies for the first time.

General insurance is the most optimistic sector covered by this briefing. A balance statistic of 40% of general insurers are more optimistic about the overall business situation. The sector is still seeing strong growth in premium income and although the rate of growth was slightly down, a balance of 67% of respondents said that the value of premium income was up over the past three months. This reflects the continuing upturn in a cyclical market and is expected to continue into the next quarter. Confidence manifests itself in projections for increases in recruitment and marketing expenditure. Unsurprisingly, in view of recent storm damage the value of insurance claims rose at the fastest rate in the survey's history.

In contrast to general insurers, **life insurers** are broadly neutral regarding business confidence. The sector remains under the threat of more intense competition and a fall in the volume of business with regard to private individuals will not have eased its concerns. For the third successive quarter, respondents feel that in volume terms the present level of business is down. A balance of 50% of respondents expect the volume of business to be up during the next quarter probably reflecting the introduction of stakeholder pensions, although the projection may be optimistic. The introduction of stakeholder pensions will also explain why overall profitability is expected to fall. To deal with the anticipated increase in volume numbers employed are forecast to rise for the first time in over a year. Training expenditure is also expected to increase and capital expenditure will be targeted at providing new services, increasing efficiency/speed and reaching new customers. The survey was completed before Equitable Life closed its doors to new business and it remains to be seen what impact this will have on confidence.

A fall in business confidence for **securities traders** reflected a downturn in activity and the surprisingly high forecast for volume growth made in the last survey did not materialise. Securities traders who were inundated with transactions earlier in the year have built up capacity which, in the current climate, is no longer required as the present level of business returns to normal, or just below normal levels. What is considered normal has however been redefined and the level of business is much higher than it was a year ago. The inability to utilise new capacity is further evidence that securities traders now believe that the reduction in new issues and merger activity since October will extend into this year. Since September, a significant number of IPOs have been pulled and UK equity turnover in the FTSE index for November had a value of £52,844m compared with a year to November 2000 monthly average of £61,781m.

The result is an increase in costs, 62% of securities traders said the trend in staff costs as a proportion of total costs was up over the past three months. Profitability is down and overall profitability recorded its first negative balance for two years. The outlook for overall profitability is not good and a balance of 24% expects the trend to be down over the next three months. The sector expects the trend in numbers employed to be down during the next quarter and the availability of staff as a constraint to business prospects is no longer an issue. This supports press reports of investment bankers imposing a freeze on recruitment.

Business confidence is down for **fund managers** and the sector, which has been piling on costs for a year and a half, appears to have hit a wall. Instead of the forecast growth, business volumes fell and only modest growth is expected during the next quarter, which is usually one of the busiest as private individuals address their financial affairs before the end of the tax year. The Association of Unit Trusts and Investment Funds released gross sales figures for October of £4,032.9m, down from September's total of £4,813.5m.

Fig 1: "Business confidence remains stable and 2000 finished with a return to normal levels of business, as opposed to the fast rates of growth and activity experienced earlier in the year."

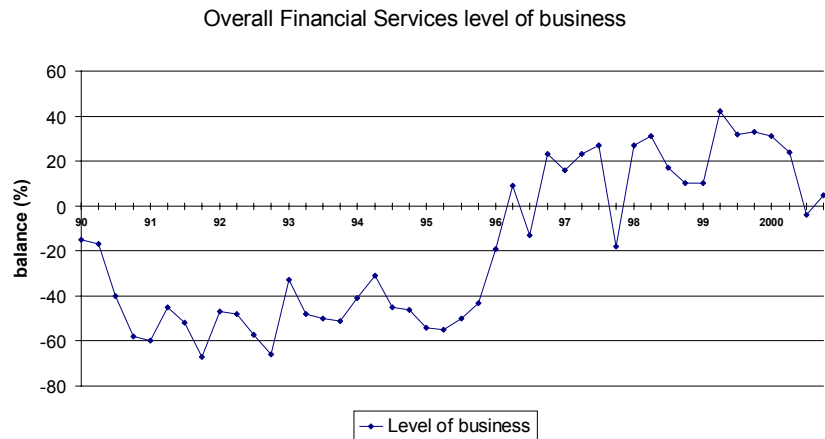
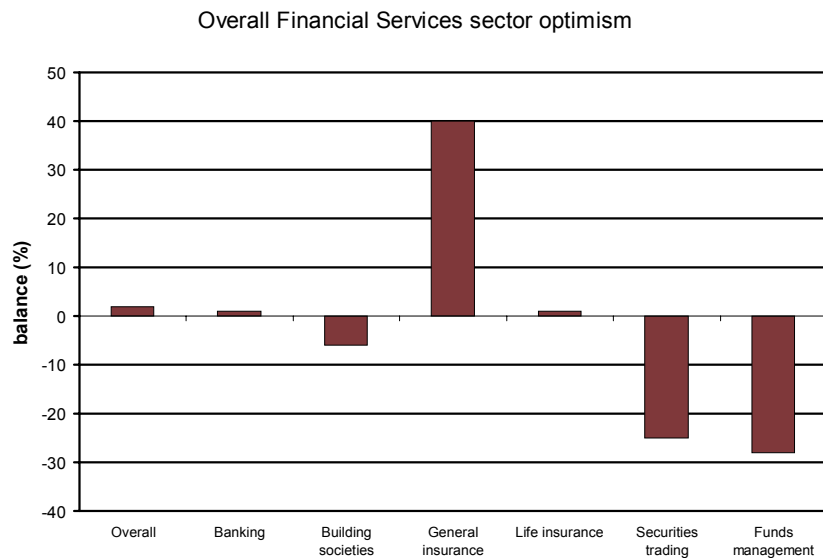


Fig 2: "...general insurers reported the sharpest rise in confidence, while fund managers, who have increased costs and capacity, reported the most significant decline in confidence."



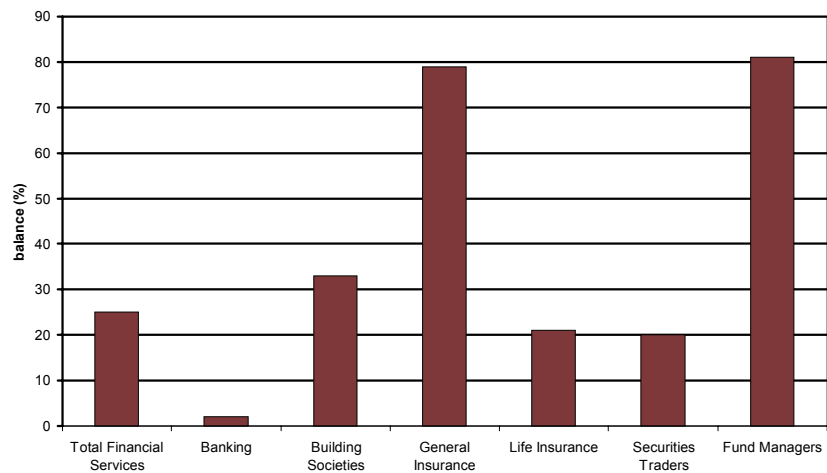
New Economy: Special Internet Survey/e-business Section

“A consensus on e-business strategy for financial services starts to emerge, which could mean a reduction in new stand alone brands”

Many people are puzzled by how limited a transformation the Internet has so far wrought on the financial services sector, bearing in mind that it offers a huge number of products that can be used, transferred and delivered electronically. One of the conclusions drawn from the CBI/PricewaterhouseCoopers special survey a year ago was that respondents were still grappling with the challenges presented by e-business and what their response should be. This new section of the Financial Services Survey aims to understand the growth of e-business activity in the UK and revisits some of the questions and issues raised at the end of 1999.

Twenty seven per cent of respondents reported that the total value of their Internet business with both customers and suppliers has increased over the past three months. This headline figure hides a variance between the sectors and the gains made by general insurers (79%) and fund managers (81%) exceed those of banks (2%) and securities traders (20%). A year ago securities traders were the first to adopt the Internet and only 60% of fund managers said that e-business was part of their business strategy. For fund managers, the figures for this quarter will probably include an element of catch up.

Q13 Over the past three months, how has the total value of your Internet business changed with customers and suppliers?

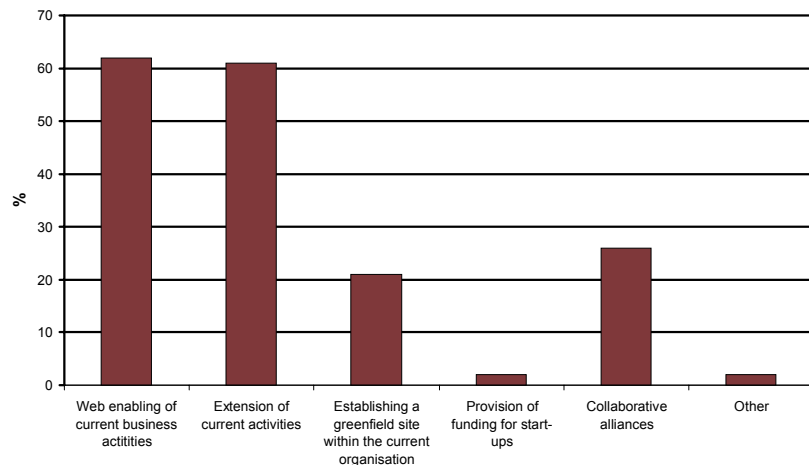


Sixty four per cent of bankers confessed that they did not know whether the increase in Internet business met their expectations or not, reflecting continuing uncertainty about customer responses to the Internet. In the other sectors covered by this briefing respondents were satisfied that growth was in line with expectations and 36% of fund managers and 15% of general insurers said that growth had exceeded their expectations. General insurers appear to be getting to grips with their Internet offering and the vast majority of large organisations have now established their own sites. In the US leading players on the Internet have made it easier for consumers to buy insurance by reducing the number of questions they require. In the UK however, there is still work to be done as insurers deal with the problem of obtaining the necessary information for underwriting.

Regarding the issue of fund supermarkets, it appears that fund managers prefer to sell their products through established supermarkets rather than set up their own. For example, Egg's fund supermarket currently claims 23 brands. Fund Managers perceive supermarkets in the same way they perceive IFAs and treat them as another channel to market. They have chosen not to establish their own supermarkets, which would bring them into conflict with their existing distribution channels.

The most common strategies adopted by respondents to develop their e-business offerings were the web enabling and the extension of current business activities. This was consistent across all the sectors and the industry appears to be reaching a consensus on the best way to address the challenge presented by e-business. At the end of 1999 respondents were deciding whether to extend their current brand or build a new greenfield operation under a separate brand. A year later 62% of respondents said they were web enabling current business activities and 61% said they were extending current business activities. Only 21% said they had set up a greenfield operation. High profile launches such as IF and Cahoot have experienced problems and this will also have stemmed enthusiasm for greenfield developments.

Q18 What strategies are you adopting to develop your e-business activities?



Twenty six per cent of respondents said they had formed collaborative alliances to develop e-business strategies. Some high profile collaborations have been announced and for Lloyds TSB with Centrica and Barclays with Mothercare the main attraction is the opportunity to mine a new seam of customers.

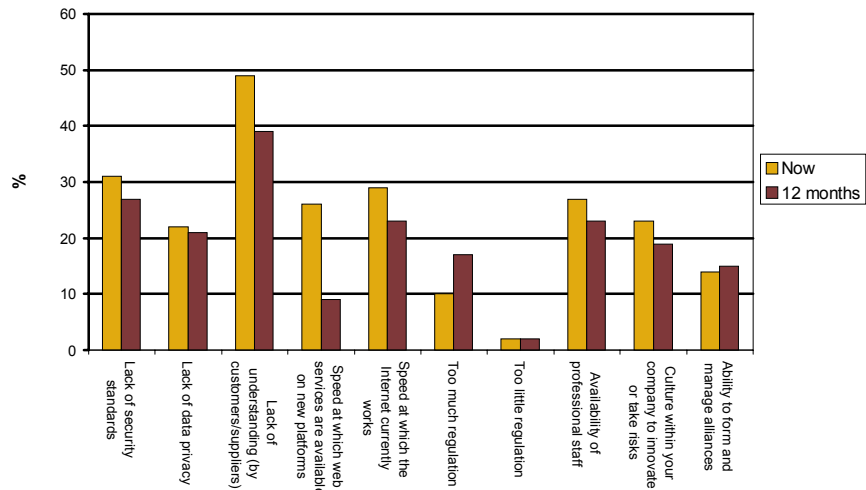
Twenty three per cent of respondents said they had launched an online brand and 12% said they planned to. More significantly 66% said they had no plans to do so. Only time will tell if this signals the start of the end for distinct online brands. Whilst some new brands have been established successfully, the jury is out on some of the others, particularly those that were established to tap a new, younger and potentially lucrative customer segment. In reality the profile of Internet users in banking matches the profile for PC ownership i.e. older and affluent.

The practicalities of building a new consumer brand also make it harder to establish a greenfield site or stand alone operation. Of the respondents who

said they had launched an online brand, the majority used conventional advertising or direct marketing supplemented by online direct marketing. This underlines the fact that brand building is expensive. When combined with the start-up investment in IT, even with the much lower marginal costs for Internet transactions, it is difficult to make a return on the costs of establishing a new operating entity. Events over the last year suggest there has been a reality check and the industry appears to be taking a more considered approach to e-business development.

In similar surveys lack of security is perceived to be the issue holding back e-business development, but in this survey, as it was a year ago, the critical barrier to e-business development remains lack of understanding, cited by nearly half of the respondents. A lack of security standards is the second most cited critical barrier to e-business development (31% of respondents), followed by the speed at which the Internet currently works (29%), the availability of professional staff (27%) and the speed at which new web platforms are available (26%). Barriers to e-business development are expected to slowly come down over the next year except for 'too much regulation'. Seventeen per cent of respondents expect this to be a critical barrier in 12 months time compared with 10% now. There have been no announcements of future e-business regulation and this expectation is probably due to uncertainty. This issue is covered in more detail in *Protect and Survive*, launched in July and available from www.pwcglobal.com/protectandsurvive.

Q17 What is the most critical barrier to e-business development?



To paraphrase a quote by a leading CEO of an old economy company, "You've showed us the way, now get out of the way", the opportunity is there for established financial services institutions to seize the initiative. Only 30% of respondents reported that competition is increasingly coming from corporates outside the financial services sector. Of the respondents that did not see an increase in competition from outside the industry, the main threat came from existing direct competitors. The threat of competition from new stand alone Internet operations has receded and other corporates are busy addressing the challenges in their own industries. The huge level of investment for media and particularly telecoms companies demands for the time being that they concentrate on their own sector. For cash rich mature industries such as Centrica's, an alliance appears to be a more attractive option.

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About this survey

The survey was carried out between 22 November and 6 December 2000. A total of 123 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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