Financial Services Survey

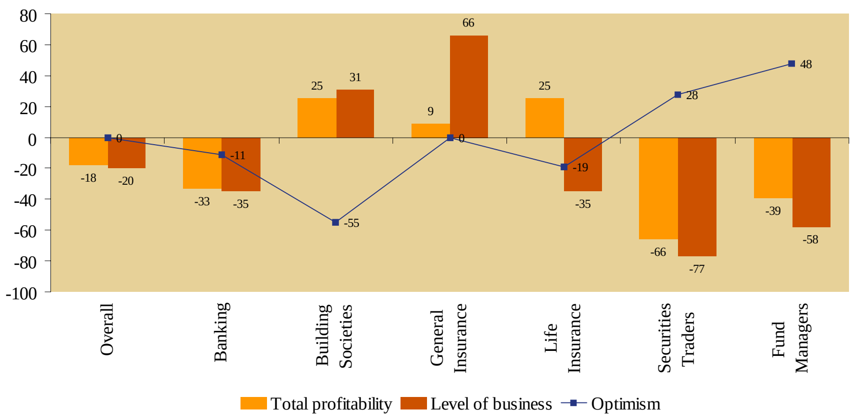
CBI/PricewaterhouseCoopers Survey

December 2001

“In spite of below normal levels of business and falling profitability, business confidence stabilises”

The 49th CBI / PricewaterhouseCoopers survey showed a return to business after the appalling events of 11 September, which overshadowed the last briefing. It also revealed a number of paradoxes; in some sectors there appears to be a disconnection between the headline confidence figures and supporting data. Business confidence has stabilised, but business levels are well below normal and profitability has fallen by the greatest extent since 1991. In most cases it would appear that despite a number of negative trends and factors in their sector, most respondents are satisfied that they have adopted the correct strategy and are doing what they can, particularly with regard to costs, to pull through a demanding period. It is this that seems to underpin the uplift in confidence since the last survey.

Figure 1 “In some sectors there appears to be a disconnection between the headline confidence figures and supporting data”



Source: CBI / PricewaterhouseCoopers Financial Services Survey

Business confidence remained low in the **banking** sector, but fell at a lower rate than was reported in September. Respondents were nervous about the longer-term outlook for consumer spending, but business volumes with private individuals remained strong this quarter with a balance statistic of +29%. Banks had expected this to fall in the last quarter of 2001, but are now forecasting a stronger increase in the first three months of 2002. The decline in business volumes with industrial and commercial customers was not as bad as predicted, but there was a big jump in non-performing lending, which will apply to the commercial sector. This is expected to remain an issue during the next quarter and banks will be nervous about the possibility of another commercial collapse.

Total operating costs fell markedly over the past quarter and staff costs as a proportion of total costs fell. In September, banking respondents said that they would take employment out and this has happened with more cuts expected in the New Year. A number of indicators suggested that competition is increasing, which you would expect; demand is lower, but there are still the same number of banks. Statutory legislation emerged as a factor likely to limit the sector's ability to increase the level of business over the next 12 months. This will reflect the concerns of banks about complying with N2 and the future regulation of mortgages. Anti-money laundering is also emerging as a major issue following 11 September with government expectations of what banks should be doing rising continually.

Business confidence for **building societies** fell to the lowest level since 1992, reflecting pessimism in the property market. The level of business rebounded compared to the September survey, although not compared to the rates witnessed in the first half of the year. A modest rise in the volume of business is expected to give way to a decline in 2002, with the trend in business volumes with regard to private individuals expected to stabilise.

Numbers employed increased as the sector took on more people to cope with the mortgage boom. However a slowing volume means that building societies, by increasing their cost base are building problems for the future. In the PricewaterhouseCoopers survey of building societies' attitudes towards shared services, 75% of respondents said cost saving was their main drive for sharing. An increasing cost base in the current environment could herald a move towards the service centre model, although the sector has been slow to embrace it so far.

Like the banking sector, the impact of statutory legislation on business prospects emerged as an issue, with particular concerns around the impact of N2 and the future regulation of mortgages. Unlike many of the other sectors covered by this briefing, building societies expect to authorise more marketing expenditure over the next twelve months than they did over the past twelve months. Domestic competition remains high as players fight harder for a declining market. The fall in the trend in the value of fee income represented a quarter on quarter change of 50 percentage points, which underlines the finding that competition is getting tougher.

In the **general insurance** sector business confidence is unchanged on the previous quarter. As always we cannot tell from the survey data what the split is between wholesale and retail respondents. However it is fair to assume that the wholesale sector is driving the rate increases reflected in the survey in the aftermath of 11 September. The value of premium income rebounded significantly over the past three months with a balance statistic of +59% reporting an increase. We know that balance sheets have been hit and some capacity has come out of the market. The sector is reassessing the amount of risk, and in a perfect market you would expect rates to remain strong, although the survey expects a slight deceleration in growth.

Rate increases appear to have bucked a potential fall in the insurance cycle. Closer analysis however, reveals that although the volume of business rose by nearly twice the level indicated in the September survey, it remains weak compared to responses over the past two years. At the time when many of the other sectors reported either a fall in total costs or an indication that costs were coming under control, general insurance reported an increase over the past quarter and predicted further increases. Along with building societies, it was the only sector to increase numbers employed. Another indicator pointing to a fall in the insurance cycle is an expansion in capacity. The need to expand capacity rose significantly in importance over the quarter and with a balance statistic of +67% is the second most cited factor influencing capital investment.

In the **life insurance** sector, business confidence weakened over the quarter and at a faster rate than during the previous six months. Overall profitability rose over the past three months, but by less than had been expected in the last survey. Business volumes fell, but a failure to get to grip with costs will have been behind the slowdown in profitability. Total operating costs rose substantially with a balance statistic of + 40% of respondents reporting an increase. A stark increase in total operating costs suggests that companies are finding it extremely hard to drive down costs.

There is a significant squeeze on profitability arising from the "1%" world of stakeholder pensions, the debate on with-profits policies and moves towards greater transparency. This will have a long term impact and there will be a lag between profits earned on business written over the past twenty years and new business. With this in mind it is worth noting that a balance statistic of +66% of life insurers said the trend in value of new business was down in the past three months. Difficulties at Equitable Life continue to cast a negative impact on the sector as a whole although some companies will benefit. There is anecdotal evidence of a flight to the perceived safety of the big brands by consumers.

A balance statistic of +28% of **securities traders** were more optimistic about the overall business situation this quarter. Although the balance statistic is relatively low, it represents a significant quarter on quarter change of 100 percentage points, but are there grounds for this turnaround in optimism? As the FTSE100 heads for its second year on year decline, critics argue that the sector underestimated the scale of the fall, but this survey did record a negative balance statistic this time last year and business confidence has been low throughout the year. It is too early to say whether the results of this survey mark a turnaround, but the IPO market, considered to be the bellwether for the sector, recorded the second busiest week of the year for US initial public offerings in December 2001. Pessimists might argue that companies cannot see an upturn in the market next year and want to go ahead anyway, but optimists will counterbalance this argument saying there are deals in the pipeline and this is a good time. There is an abundance of cash to be invested, particularly in the current environment of low interest rates.

Business volumes fell more sharply than respondents forecasted, but are expected to increase over the next three months. During the period covered by this survey, the secondary market on the London Stock Exchange recorded its highest daily number of bargains this year and so to understand the volume trend we need to look at the figures in more detail. This data suggests that investors are moving out of equities and into cash or bonds. The volume of business with private individuals continued to decline significantly and this is one sector which may not see an early recovery. It is the retail investors who got hurt when the stock market dropped and it is unlikely that they will return in a hurry.

In September's survey, **fund management** experienced a fall in both business volumes and overall profitability. The trend continued, overall profitability decreased markedly and the volume of business fell sharply, at a similar rate to that previously expected. This quarter's increase in confidence was driven more by cost control than revenue growth and fund managers expect a sharp increase in overall profitability in the months ahead. A balance statistic of +39% of fund managers expect overall profitability to be up over the next three months, a quarter on quarter change of 70 percentage points and the first positive balance statistic for 15 months.

The sector has made significant investments in straight through processing, 94% of respondents said the most important reason for planned capital expenditure is to increase efficiency. The sector continues to experience consolidation, but paradoxically fragmentation is also occurring as non-core businesses are sold or outsourced. Fund managers are keeping niche brands and combining back office systems where straight through processing appears.

New Economy: e-business section

The survey revealed a steady increase in the total value of Internet business with both customers and suppliers over the past three months. The balance statistic of 28% represented a similar rise to that reported in September, but the rate of growth remains below expectations.

The proportion of customer transactions initiated online has now reached between 1 and 10 per cent with the banking sector most advanced and the fund management sector least advanced. In 12 months time, most respondents are expecting to see it rise to between 10 and 20 per cent.

The number of business transactions initiated via the Internet with suppliers is generally lower than with customers. While some growth is expected over the next 12 months, B2B activity does not appear to be developing as fast within financial services as it is with other industries.

The barriers to e-business development have reduced slightly since the last survey and are expected to reduce further over the next 12 months. The most cited barrier to e-business development remains a lack of understanding on the part of customers and/or suppliers (cited by 56% of firms). Other significant barriers are the speed at which the internet works (35% of firms) and a perceived lack of security standards (34%).

Analysis by sector shows building societies and fund managers are most concerned with security issues while banks and securities traders are more concerned with lack of understanding. This suggests that banks and securities traders, as the early adopters, are now concentrating on getting customers to use what they have built, while the late adopters, fund managers and building societies are encountering the problems faced by banks a couple of years ago. Fund managers are increasingly pursuing wealth management solutions, for which aggregation poses a significant opportunity but also raises major security concerns.

The most common strategies to develop e-business activities remain web enabling of current business activities and the extension of current business activities. Establishing green-field sites and starts-up remain out of favour.

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This bulletin is produced periodically to address important issues affecting the financial services industry. If any of your colleagues would like to be added to the mailing list or if you do not wish to receive further editions, please write to:

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About this survey

The survey was carried out between 21 November and 5 December 2001. A total of 129 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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