

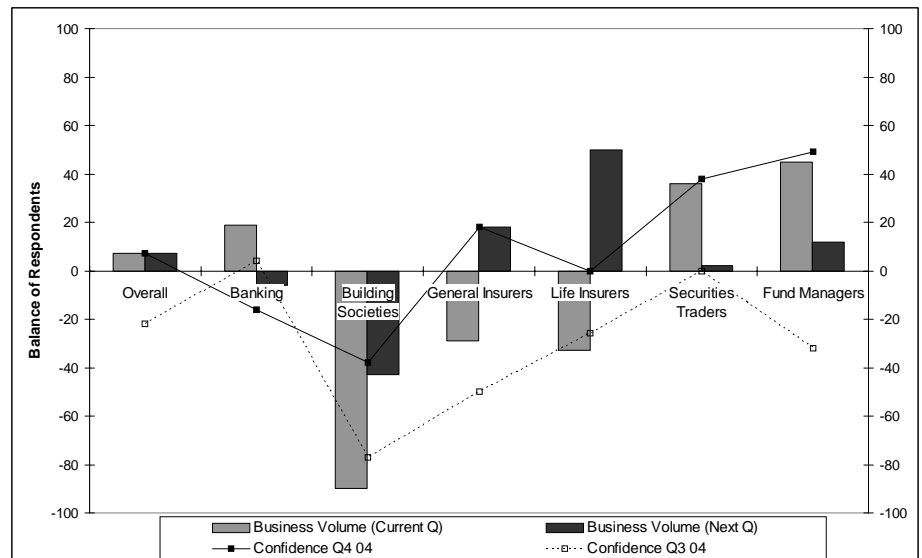
CBI/PricewaterhouseCoopers Survey

December 2004

“The unmistakable signs of a slowdown in mortgage and consumer lending make their mark”

The 61st CBI/PricewaterhouseCoopers financial services survey reveals a cautious overall increase in optimism, an improvement on the last quarter if not a strong rebound. Despite the perception that interest rates may have peaked, the unmistakable signs of a slowdown in mortgage and consumer lending make their mark on the survey results, with sentiments continuing to vary widely between different sectors. Banking and building society respondents reported a more pessimistic mood, with the downturn in banking sentiment particularly notable given the resilience of this sector during recent periods. In contrast, general insurers, securities traders and fund managers make a strong return to optimism. Although several sectors reported lower business volumes, it is the banks and building societies that have the negative expectations for business in the coming months. The other major sectors forecast a recovery in their volumes.

Figure 1: “Although several sectors reported lower business volumes, it is the banks and building societies that have the negative expectations”

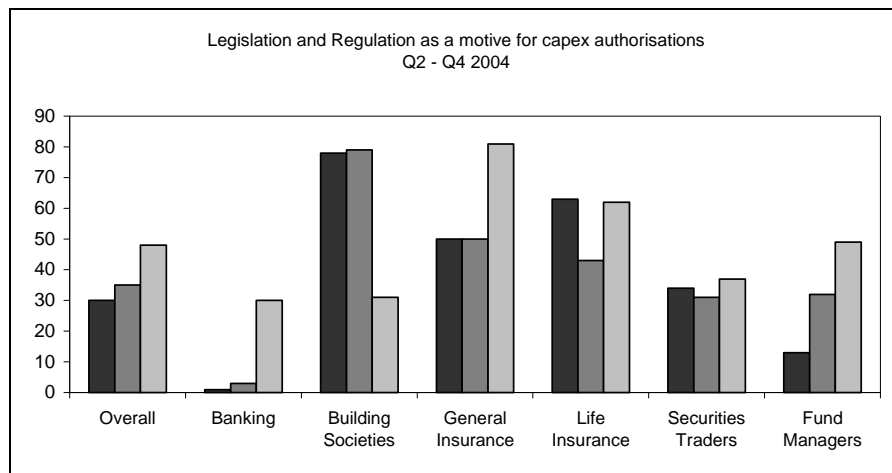


Aggregated expense levels have remained more or less flat during the quarter, with a modest balance statistic reporting improved overall profitability. However, these results also conceal some contrasts; while most sectors claim to have controlled or reduced cost levels during the period, banks and securities traders have allowed expenses to grow. Employment levels vary among the different sectors too, but the industry’s overall trend of staffing reductions has been maintained and is expected to continue.

Respondents remain cautious when reviewing their prospects for 2005, citing levels of demand, the effects of competition and the impact of regulation as the dominant concerns. A modest number are planning to invest more in IT,

largely motivated by the need for replacement and the search for greater efficiency. Regulatory pressures are the fastest growing driver of investment spending (see Figure 2).

Figure 2: “Regulatory pressures are the fastest growing driver of investment spending”



A balance statistic of -16% of **banking** respondents felt less optimistic during the quarter, the first negative result for two years. The end of the consumer credit-boom is at the root of this altered view; business with private individuals fell by the largest balance statistic in over a decade. There was better news from the commercial sector, with non-financial corporate business reported to have increased strongly. Further growth is predicted in this area, reflecting the banks' view that UK plc will benefit from stabilised interest rates. Overall business volumes increased slightly, although the positive effects of lower levels of loan re-pricing on interest income were offset by the impact of slower consumer borrowing on fees. With interest rates now appearing to have peaked, average spreads did not expand as hoped, but were reported to have fallen by a balance statistic of -55%. This was the most negative response in eight years, owing to the flattening of the yield curve and the effects of competition.

The pessimistic outlook for consumer borrowing has encouraged a greater focus on expenses. Although higher total costs were reported, costs per transaction appear to remain well controlled and staffing levels fell, as had been predicted. Headcount reduction looks set to accelerate, with a balance statistic of -63% expecting further shrinkage in the coming period. Training expenditure grew, driven by the need for compliance with mortgage and general insurance regulation. Profitability fell and is not expected to recover in the next three months. Looking ahead, negative sentiment seems to have affected the sector's capital expenditure plans; IT investment intentions were lower for the second quarter running, and branch refurbishment spending appears to be tailing off. In a further sign of caution, 'increasing efficiency' reached its lowest ever level as a motive for investment. This is in contrast to the growing role of regulation as an investment driver, as the banks gain greater clarity over the details and timeframe of Basel II implementation.

Building societies reported another quarter of negative sentiment. The balance statistic of -38% that reported feeling less confident was a slight improvement on the prior quarter, but the slowdown in the mortgage market is clearly taking its toll. A balance statistic of -90% reported lower business volumes and less commission income, with -88% also noting a downturn in business with the consumer segment. Each of these three data was the most

negative recorded in over a decade, confirming the impressions conveyed by recent releases from the Bank of England, the Halifax and elsewhere. Steadying average spreads gave the sector some respite during the quarter, reflecting a slowdown in the re-pricing of back book loans. However, downward pressure on margins is forecast to resume, owing to the sheer weight of market competition. More encouragingly, respondents' persistent concerns over non-performing loans are yet to materialise, suggesting that the average affordability of debt remains reasonable.

Building societies' overall costs were reported to have fallen during the period, largely explained by the impact of lower business volumes on the level of brokers' commissions. In contrast, per-transaction costs grew, driven by falling volumes and the twenty-fourth consecutive quarter of reported staffing growth. A majority of respondents forecast further increases in headcount and training expenses; since it is hard to imagine the business logic for this growth, mortgage regulation is the most likely driver. Nonetheless, a surprising balance statistic of +60% reported stronger overall profitability. Given the negative responses made elsewhere, the slowdown in margin erosion may have coloured answers to this question. Regulation is expected to be a lesser concern in the coming year, but all respondents see demand levels and competition as potential limiting factors. Considering this pessimism, it is surprising to find that a majority of societies plan to increase capital expenditure in every area during the next twelve months.

Confidence among **general insurers** improved as the balance statistic measuring overall optimism moved up to +18% from -50% in September. There have been conflicting pressures: On the one hand, respondents reported a fall in premium income over the past three months; on the other hand, investment income has increased, and operating costs and claims have decreased. Looking forward respondents are, perhaps surprisingly in view of recent comment regarding a softening market, expecting premium income to increase. Costs are expected to continue to reduce, while a benign claims environment is also expected to continue with little change expected in the value of claims.

It is likely that UK personal lines have had a significant influence on the survey results. In general terms profitability appeared to hold up well, supporting the more optimistic forecasts that good profitability will last for longer in this cycle than has historically been the case in the UK. Looking at the figures over recent periods it is noticeable that claims have usually undershot previous sector expectations, sometimes quite significantly. For example the 'last three months' balance statistic in December of -28% contrasted with a 0% balance statistic for 'next three months' in the September survey. This profile clearly would not support assertions of a rising 'compensation culture' detrimental to insurers. Whether there is a 'compensation culture' or, as some commentators have recently suggested, the notion is an 'urban myth', the favourable claims outcome is an important and positive near-term feature for UK insurers, that may reflect a surprising level of success in managing the claims pipeline.

There is an expectation of increases in training expenditure and in staff costs as a proportion of total costs, both of which are likely to be connected to the introduction of FSA regulation of the mediation of general insurance sales. Capital expenditure is primarily related to efficiency increases (99% of respondents) and, again, costs associated with regulation (81% of respondents), but not to reaching new customers, which was cited by only 36% of respondents.

Industry opinion about the overall business situation is finely balanced amongst **life insurers**; the balance statistic improved from -26% in September to 0% in December. There is a clear distinction between experience over the last three

months and more positive expectations about the next quarter. Balance statistics of -21% and -47% for value of premium income and value of new business respectively over the period contrast with balance statistics of +49% and +50% for the next three months.

A positive trend in investment income was recorded with a balance statistic of +13%, but perhaps more noticeable were the very strong opinions recorded around success in cost reduction. Almost all respondents have seen declines in operating costs per transaction and expect more going forwards, with balance statistics of -96% for the last three months and -97% for the next quarter. These trends will have contributed to overall profitability, which has clearly improved, evidenced by balance statistics of +61% and +60% for the current and forecasted periods respectively. Given respondents' negative opinion about recent new business profitability, it must be assumed that cost reductions have significantly improved in-force profitability. It would also be logical to expect the final months of the old pre-depolarisation regime to have produced a hiatus in marketing efforts as providers refocused on the new landscape; in this respect the +73% balance statistic for marketing expenditure in December contrasts notably with the -12% for the previous period.

Regulation is the biggest factor behind capital expenditure. This relates to both prudential and sales regulation. Continuing a well established trend, uncertainty over demand is a key limit to increasing the level of business. The ability to raise funds is a declining factor in this respect, being cited by only 35% of respondents compared to 63% in the prior period. This no doubt reflects the generally improved capital position of the industry and successful capital raising by Prudential and Friends Provident during the quarter.

Securities traders reported greater optimism during the quarter, with a balance statistic of +38% feeling more positive. After an extended period of subdued business over the summer, positive expectations for the autumn appear to have been justified by a pick-up in activity. Respondents reported increases in transaction volumes, with activity feeding through to stronger commission income and trading revenues; these positive results fit the picture of strengthening volumes reported by the UK equity and derivative markets in recent weeks. Modest improvements were noted across all customer sectors, although this growth was not forecasted to continue into the current quarter. Nonetheless, there are hopes in the market that global economic recovery together with greater political stability will make 2005 a better year for the sector.

Turning to costs, the picture appears less encouraging. Respondents reported a small increase in staff levels as well as a more significant increase in marginal transaction costs (balance statistic of +38%). With volume levels increasing the total cost base of the sector was also reported to have grown by a balance statistic of +37%, though this was perhaps by less than might have been expected. In spite of the higher cost levels stronger profitability was reported, though securities houses remain cautious about the coming quarter. A modest balance statistic are planning more IT investment, but the major motivations for this expenditure are replacement and improving efficiency. Levels of demand are the sector's greatest preoccupation, and 61% are also worried about the potential effects of regulation on their business.

A balance statistic of +49% of **fund management** respondents felt more optimistic during the period, making them the most confident of the major sectors. This result represented a strong recovery from the previous two surveys, which had shown surprising negativity, especially in the context of positive investment flows and stabilising markets. Renewed optimism appeared to stem from a combination of strong trading levels and good operational data. Volumes of business recovered well, with commission

income reported to have increased by a balance statistic of +88%. Another positive factor was that commissions paid were reported to have fallen, not unexpected in the current climate but an interesting contrast to the responses of securities traders. Not all customer segments impressed however; although a balance statistic of +38% reported more activity with financial institutions, business with non-financial companies was said to have reduced. It was also notable that growth appeared to be UK driven, with overseas custom seen as weaker than domestic business.

On the expense side, fund managers are finally reaping the rewards from the infrastructure improvements made during recent years. Total expenses remained flat; costs per transaction fell; and both measures are expected to decline further in the coming quarter. Staffing trends were a key driver of lower costs, as respondents continued to reduce headcount. At the same time, the sector seems to have recognised the need for better training, with regulation a particular driver of increased costs in this area. Overall control of expenses combined with stronger income to improve profitability, which saw a strong up-swing to a balance statistic of +82% from a previous level of -64%.

After an unexpected blip in the last quarter when fund managers planned to reduce IT investment, a positive balance statistic of +38% shows that the sector now expects to spend more in this area. This reflects fund managers' active use of IT spending as a means to reduce headcount and improve efficiency; against this, regulation is increasing costs as documentation requirements continue to build.

e-business section

The proportion of customers using web-based services continues to grow, at an annualised rate of roughly 20%. In the average financial services company, roughly 15% of customers now use the web, with a third of companies reporting more than 20% of customers doing so. It is, however, sobering to note that at the current rate of growth it will take another decade for the web to achieve full penetration into the customer base. The main obstacle to increased usage remains customer preference for other channels, with customer concerns about security and data protection still a significant factor following the recent publicity over 'phishing' attacks and other security glitches. Against this, there has been a marked improvement in customer knowledge of the internet - only 14% of companies reported this as a significant barrier compared with over half just nine months ago.

What does the future hold? E-business now seems to have become business as usual, with the focus on web enabling existing business activities and extension of current web activities. New ventures, start-ups and collaborative alliances seem to be off the corporate agenda. So, expect slow steady growth from the internet channel, rather than a wholesale change in business models.

Financial Services Survey

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 22nd November and 3rd December 2004. A total of 93 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. The price for a single quarter for members is £60 and for non-members £95; an annual subscription for members £210 and for non-members is £360.

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