

CBI/PricewaterhouseCoopers Survey

September 2005

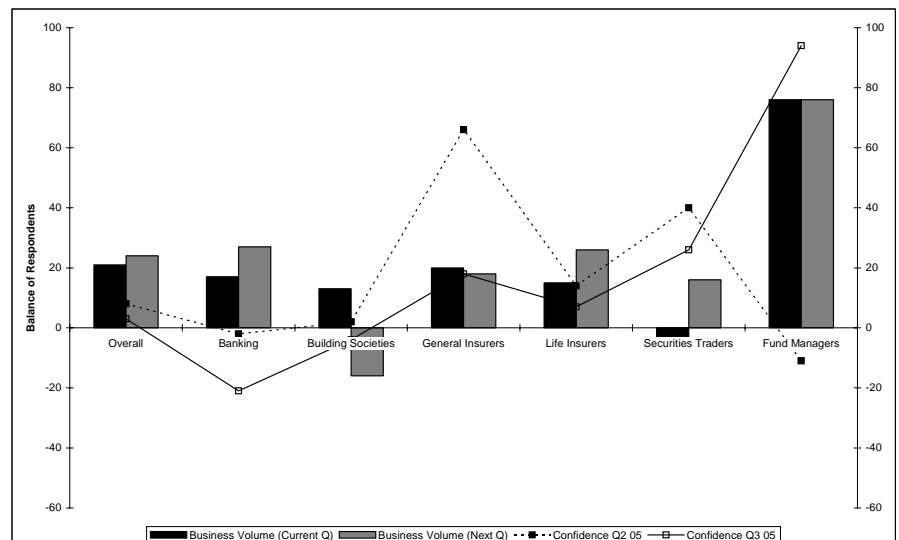
“The survey shows the recovery in business activity is gathering pace across most parts of the industry”

The 64th CBI/PricewaterhouseCoopers financial services survey shows the industry feeling slightly more confident than in the previous quarter. This steady result suggests a degree of caution, since the survey shows the recovery in business activity is gathering pace across most parts of the industry. In particular, volumes of business and the value of income are reported to have grown positively after several quiet quarters. As ever, the growth expectations of different sectors vary. Fund managers are the most bullish and building societies the most cautious, but overall the sectors present the most consistent picture of growth for several quarters.

With the exception of the banks, most sectors allowed their costs to rise during the period. However, the widespread reports of improved profitability suggest that expense growth remains controlled, and this is expected to continue to be the case. On a positive note, most sectors report higher headcount, with plans to further expand employment in the coming months.

The industry appears to be increasingly upbeat about its medium-term outlook, with overall levels of IT investment predicted to rise by the largest balance statistic in five years. Marketing expenditure is also expected to expand during the coming year. Respondents anticipate the factors likely to limit business development to remain largely unchanged, but some sectors report a fresh upturn in concerns about the impact of statutory legislation and regulation.

Figure 1: “Fund managers are the most bullish and building societies the most cautious, but overall the sectors present the most consistent picture of growth for several quarters”



A balance statistic of -21% of **banking** respondents report feeling less optimistic about their business situation. This is the most negative response for two years, which seems surprising given other, more positive results. Volumes and the value of all types of income are seen as having grown, and are forecast to expand further. An upbeat assessment of retail custom implies that consumer borrowing remains active, and a balance statistic of +47% predict further growth in this segment. The outlook for corporate business is also improving, after an unexpected dip in the prior quarter's survey. Considering these encouraging results, the downbeat headline confidence number may reflect short-term worries over energy price shocks and their potential impact.

Average spreads remain under pressure but are expected to stabilise, with banks expecting interest rates to remain at their current levels in the short term. A modest balance of respondents say non-performing loans are growing, but this conceals a degree of offsetting between higher consumer arrears and falling bad debts in the corporate area.

The banks appear to be maintaining their perennial focus on efficiency; lower costs are forecast and improved profitability is predicted by a balance statistic of +54%. Nonetheless, staff and training costs are expected to expand as volumes grow, and capital expenditure plans are upbeat. Branch spending is expected to continue, and IT investment is predicted to grow by the highest balance statistic in five years as the sector expands cost-saving initiatives. Regulation is one potential limitation on the horizon; it has climbed slightly as a concern from the low levels of recent quarters as banks become increasingly concerned about the regulatory outlook for consumer lending.

A balance statistic of -4% of **building societies** are feeling less optimistic, despite reporting slightly higher volumes of business during the quarter. Levels of business are expected to ease off in the next three months, but some other results suggest cautious optimism. Most notably, a balance statistic of +34% predict that business with private individuals will recover in the coming quarter. This probably reflects seasonal expectations for the housing market, but it is worth noting that a similar prediction made in the first quarter of the year did not in fact lead to higher volumes. For the second survey running, a strong majority of respondents report increased commission income. Considering the strong reported declines in spreads, this suggests that societies are shifting towards mortgages that offer competitive interest rates but carry higher up-front fees. In a less positive development, the value of non-performing loans increased for the third quarter in a row.

The sector's return to expense growth appears to be gathering momentum, with a balance statistic of +65% saying that total costs have grown during the past quarter. The majority expect this to continue, and over two thirds of respondents have also increased their headcount. These indicators of cost inflation are surprising given the expectation of lower volumes, and make the sector's reports of increased profitability particularly hard to interpret. Furthermore, the societies appear to have quite bullish investment plans. Providing new services is given as a reason for capital expenditure by 96% of respondents. This is one of the highest ever results, and shows the sector is continuing to develop new types of savings products and more competitive mortgage packages. Nonetheless, concerns about the outlook remain. Demand levels and the threat of competition are seen as threats to business by every respondent, and the perceived threat of consumer protection legislation has rebounded to a high level.

General insurers remain optimistic, though less so than three months ago. A balance statistic of +18% report feeling more confident, compared to +66% in the prior quarter. Respondents are positive about volumes of business but neutral about premium income, a picture that is consistent with some

weakening of rates and perhaps more accommodating terms and conditions. This scenario would normally encourage commercial customers to expand insurance buying, and respondents are indeed more optimistic about commercial business than they are for retail customers. The major positive trend is around investment income, where an identical +57% balance statistic applies to both the past and coming three months.

As regards claims, a very benign period may be drawing to a close. The value of claims is now expected to rise, as indicated by the first significant positive balance statistic in a year (+21%). Procedures for handling claims under conditional fee arrangements (CFAs) for claimants' advisors are beginning to settle down. In recent years insurers' claims experience may have benefited from a log-jam of cases in the courts created by legal challenges to CFAs, and it could be that this phase is now beginning to pass.

The sector's focus on defending existing profitability is indicated by the 99% of respondents that cite increased efficiency as a reason for capital expenditure. In contrast, only 27% see the provision of new services as a reason to invest, a drop from 89% in June. The market remains extremely competitive; 99% of respondents cite competition as a limitation on expansion but only 44% are concerned about demand, a fall from 76% in the prior quarter. The challenge for respondents, as ever, is to obtain business at the right price in the face of competition.

Life insurers are feeling a rather cautious optimism. A balance statistic of just +7% report greater confidence, reflecting optimism about the volume and value of new business being written. As regards volume of business, it is noticeable that respondents are more upbeat on corporate activity and less confident about business from individuals. This indicates the continuing buoyancy of UK group pensions business, as new or expanded defined contribution schemes continue to replace defined benefit schemes, with which insurers' involvement was often more limited. Nonetheless, uncertainty about demand over the coming year is very high, with 93% of respondents citing this as a factor likely to limit investment. The longer term pensions landscape remains highly uncertain, with the Turner commission expected to report during the coming quarter, and pensions 'A' day coming into view in 2006. Whilst the pensions market should expand, there may be a risk that insurers will be in more direct competition with asset managers. This uncertainty may explain the predictions for marketing expenditure, which a balance statistic of +60% anticipate will increase over the coming year.

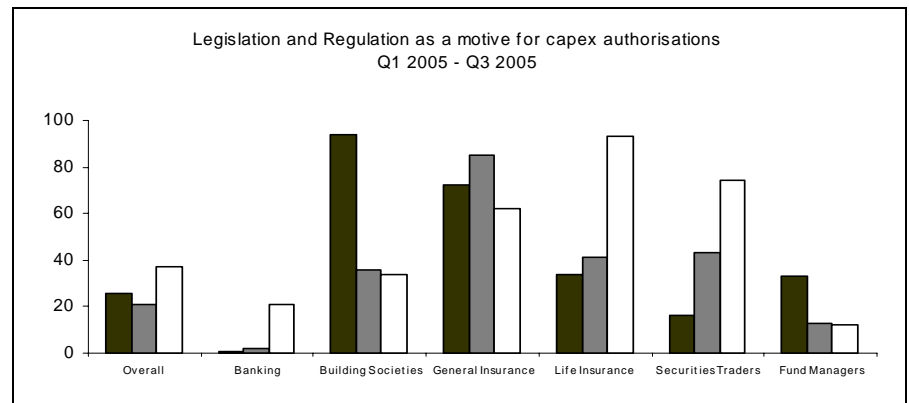
Finally, the efficient deployment of capital remains a key issue for the sector. The percentage of firms citing inadequate return on capital as a limiting factor on capital investment has jumped from 74% to 93%, which may reflect pressure on returns on new business. Even so some investment is unavoidable, with 93% of respondents (up from 41% in the prior quarter) forecasting legislation and regulation to be a driver of capital expenditure in the coming year. Similarly, 93% of respondents see the push for efficiency gains as a driver of investment.

A balance statistic of +26% of **securities traders** are feeling more optimistic. This is the fourth consecutive quarter of greater confidence reported by the sector, and the results show a generally positive outlook. Although a balance statistic of -7% report lower business volumes, income and activity levels are positive and predictions are upbeat. Commission and trading revenues are seen as having grown during the period as traders capitalised on stronger activity in the financial markets. In particular, firms have benefited from higher levels of volatility and hedge fund trading strategies that rely on this uncertainty. Business with private individuals was seen as having remained static – not an exciting result but an improvement on the prior quarter – and a balance statistic

of +26% expect to see greater demand from financial institutions and overseas customers in the next three months.

Stronger performance and expectations of further volume growth seem to be encouraging securities firms to increase their cost base. Recruitment levels are a key driver as traders add staff to deal with higher volumes. Anecdotal evidence suggests that some are turning to temporary heads where they have been unable to recruit permanent skills. The prior quarter's predictions of better profitability come through as expected, although cost growth threatens to reverse that trend in the coming quarter. Looking forward, there are further signs of confidence. Marketing spend is predicted to rise by the highest balance of respondents in five years, and capital investment plans are bullish. Two motivations for investment make noticeable jumps in the current survey; improving efficiency is now a priority for 99% of respondents, and meeting the requirements of regulation are a factor for 74%. The requirements of Basel II implementation are the key driver of regulatory spending, and are the most likely cause of longer-term concerns about regulation and its impact on business development.

Figure 2: "Some sectors report a fresh up-turn in concerns about the impact of statutory legislation and regulation"



Fund management respondents report a huge rebound in confidence, with a balance statistic of +94% feeling more optimistic. This is the second consecutive quarter to show a strong swing in sentiment, after the high optimism of the March survey was succeeded by unexpected pessimism in June. This time around, the sector's optimism appears to be more in tune with its other responses, although the degree of confidence is unexpected. A strong majority of respondents see their business volumes and revenue streams as having increased in value during the quarter, and expect them to continue to expand. These positive results reflect the continuing rally in equities and the success of alternative investment offerings. Many investment houses are experiencing strong demand for newly developed products, as shown by the successful recent launches of several real estate funds. In another encouraging sign for the sector, a balance statistic of +76% report an increase in business with both private individuals and overseas customers.

In terms of costs, fund managers seem to be going through a growth phase, with three quarters of respondents reporting higher levels of expenses. This represents unusually rapid growth for a sector with mostly fixed costs, and is explained not so much by business volumes as by the rollout of new products. Despite cost inflation, higher volumes have had a positive effect on profitability, which is reported to have improved by a balance statistic of +71%. Other forward-looking indicators suggest the sector is in an investment phase, with headcount continuing to rise and capital expenditure increasing, particularly for

IT. Among the reasons given for higher investment, it is notable that expanding capacity has grown to its highest level in eight years.

e-business section

The current survey results show that the level of e-business development in financial services continues to grow, mirroring the rapid growth in Internet adoption across the UK as a whole. Higher numbers of customers than ever before are reported to be using web-based services, and respondents' expectations for future development continue to become more optimistic. For the first time, a third of respondents now report that more than 30% of their customers are using the Internet, and a quarter of respondents now expect customer adoption of web-based services to exceed 50% within a year.

The perceived barriers to e-business adoption have not changed hugely. Well publicised events such as the recent cyber break in at a US payment processing company mean that customers' security concerns are still seen as the greatest barrier to growth. This is now perceived as a greater problem than it was a year ago, and a recent consumer survey suggests the problem is not limited to financial services but extends across B2C e-commerce. However, there has also been a positive development; the reluctance of customers to use the Internet as a channel is now seen as a falling barrier. Only 37% cite this factor as a problem, compared with 55% six months ago. If financial services customers are really becoming more willing to transact online, that will be something for the industry to celebrate.

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:

Kirsty Parker
PricewaterhouseCoopers
Southwark Towers
32 London Bridge Street
London SE1 9SY

or send an email to:
kirsty.parker@uk.pwc.com

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About this survey

The survey was carried out between 23rd August and 7th September 2005. A total of 89 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.

For further information about this bulletin, please contact Kirsty Parker, PricewaterhouseCoopers on 020 7804 7718.

To discuss the implications for the various sectors, please speak to your usual PricewaterhouseCoopers contact or one of the following people on 020 7583 5000.

Banking and Building Societies

John Hitchins

Capital Markets

Phil Rivett

Fund Management

Pars Purewal

Insurance

Clare Thompson