

Financial Services Survey

CBI/PricewaterhouseCoopers quarterly survey

Sharing insights and trends from the financial services industry*

March 2007 – Number 70

“The overall story of the quarter was one of solid volume and revenue growth, although several sub-sectors expect a slowdown”

The 70th CBI/PricewaterhouseCoopers financial services survey shows the industry’s overall level of confidence improving slightly, with most of the major sub-sectors reporting steady or improved sentiment. The overall story of the quarter was one of solid volume and revenue growth, although several sub-sectors expect a slowdown in the coming months. Nonetheless, it was pleasing to see that, on aggregate, activity increased across all customer segments. Further growth is also predicted from retail and commercial customers alike.

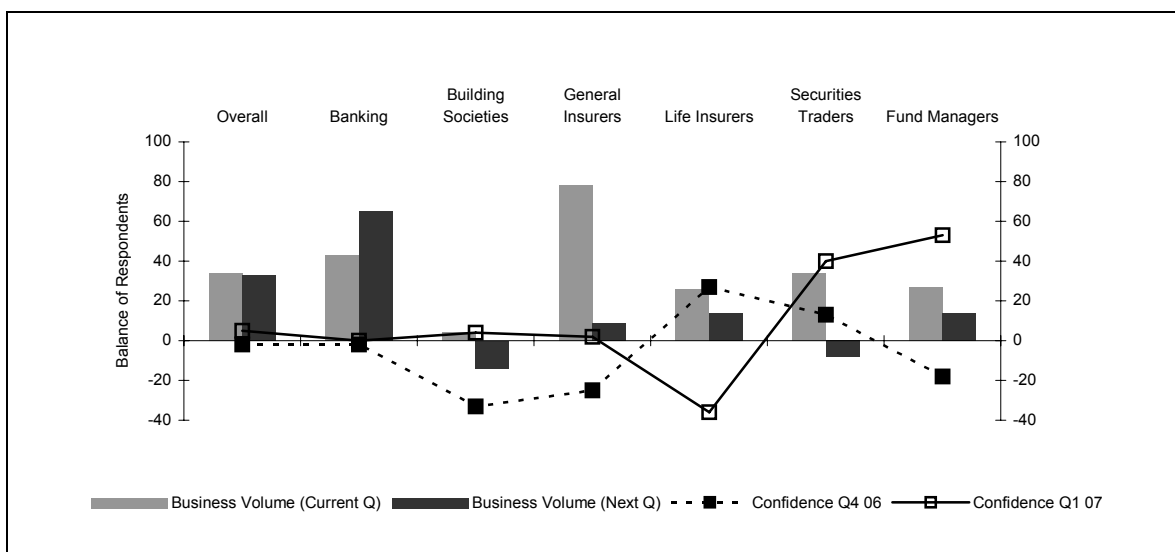
The only major sub-sector reporting a downturn in sentiment was the life insurance industry, where sentiment was affected by stock market fluctuations and increasing competition. A topical question also revealed that December’s white paper ‘Personal Accounts: A new way to save’ is giving the life companies pause for thought about their medium-term outlook. In contrast, the responses of fund managers - who should be well placed to capitalise on

the planned changes - imply that they have yet to make a full assessment of the proposals’ potential impact on their business prospects.

The healthy volumes reported during the quarter have not translated into stronger profitability for every sub-sector. Margin pressures were reported across many areas of the industry, and as their businesses have grown many financial services companies have allowed their cost bases to expand. A jump in staff turnover – not altogether surprising in the first quarter of the year – was the key driver of expense growth.

Looking to the year ahead, the industry’s capital expenditure plans continue to be broadly upbeat. Spending on regulation and compliance remains a key theme, especially among sub-sectors most exposed to the impact of MIFID.

Figure 1: “The only major sub-sector reporting a downturn in sentiment was the life insurance industry”



Banking

Overall sentiment in the banking sector remained steady for the third quarter running, with respondents reporting no change in their levels of confidence. However, most of the banks' other responses remained positive, in spite of the economic and regulatory pressures acting on the sector. Volumes of business during the quarter were higher than had been expected, and a balance statistic of +65% expect further improvement in the coming three months. Business with industrial and commercial companies grew, confounding the negative forecasts of December, and further expansion is predicted for the coming months. This is consistent with the strong levels of corporate transactions seen during the early months of the year, and represents an encouraging indicator for the economy at large. Activity with private individuals too was reported to have increased, and a balance statistic of +67% expect buoyant demand for savings and the still-growing mortgage market to deliver further growth.

The banks report a downward trend in net interest income. Average spreads are predicted to contract by the largest balance statistic in ten years, reflecting both the competitive pressures at work in the sector and changes in mix, particularly in the personal sector where a greater proportion of new lending has been in fine margin mortgages. In contrast, a balance statistic of +36% expect fee income to grow, despite recent media and political interest in retail banking charges. The banks have maintained tight control on the costs side, despite a jump in staff turnover during the period. The value of non-performing loans grew in line with expectations, but is now predicted to stabilise even though delinquencies in the unsecured consumer portfolio are expected to continue climbing. It is therefore surprising to see that a balance statistic of +36% of banking respondents expect to grow unsecured consumer lending in the coming quarter, a turnaround from the previous survey. This is a particularly unexpected result given the recent public statements of caution made by some of the banks.

Looking to the future, the banks expect to maintain positive levels of capital expenditure over the coming year, with an eye to efficiency gains and reaching new customers. However, considering the regulatory environment facing the sector it is remarkable that growth in compliance-focused expenditure appears modest. Perhaps the banks are simply becoming accustomed to the ongoing expansion of their compliance burden.

Building societies

A balance statistic of +4% of building societies feel more confident about their business situation, their first positive response in a year. The rally in sentiment points to a sense of relief that house prices and the mortgage market have remained stable, despite the interest rate increases of 2006. The stabilisation in sentiment is in contrast to the sector's other responses, which have a downbeat feel. Volumes of business and levels of income were reported to have been stable during the quarter, but there are negative predictions for activity and revenue in the coming period. Business with the all-important retail segment shows a similar profile, having increased during the past three months, but now being predicted to decline by a balance statistic of -14%. All these results reflect the consensus view that the UK mortgage market is likely to slow to mid-single digit growth rates in 2007. In the context of a slowing market, the societies continue to report erosion of spreads, with a balance figure of -89% experiencing pressure during the period. Again, this is not unexpected considering the intense competition in the vanilla mortgage market, or the recent flattening of the yield curve which has restricted the sector's ability to make a spread between short term deposits and long term lending. More positively, pressure on spreads is expected to ease – if not reverse – in the coming months, and this is reflected in the societies' stable predictions for profitability.

As had been predicted, non-performing loans were reported to have grown by a strong majority of respondents. However this trend is now expected to stabilise, and any increases are likely to be have been very modest in absolute terms. When looking to the coming year, the societies have not changed their investment plans or business outlook since December. One notable response is that 85% of respondents – the most in over two years - see regulation as a potential limitation on their business. This may be a reflection of recent press interest in mortgage exit administration fees, and the concern that this could lead to greater regulatory scrutiny in the year ahead.

General insurance

The overall confidence of general insurers improved slightly during the period. A balance statistic of +2% reported greater optimism, the first positive shift in over a year. The improved volumes of business predicted in the last survey came through during the quarter and premiums have also increased. The majority of growth continues to be driven from personal lines, although predictions for volumes and premium income point to more modest improvements in the coming quarter.

The survey shows significant growth in the value of insurance claims, reported to have climbed a balance statistic of +89%, as the propensity to claim and the average value of claims continue to increase. Operating costs were also reported to have grown by a balance statistic of +58%, with staffing costs apparently the major driver. A substantial majority of respondents saw staff turnover accelerate during the period, and a balance statistic of +67% said that staffing costs had

increased as a proportion of total expenses, the strongest such response in over fifteen years. Spending on regulatory compliance is also on an upward trend, with a balance statistic of +80% expecting to spend more on this area in the coming year.

Given the upward pressures on claims and operating costs it seems reasonable to suppose that, in spite of higher rates, combined ratios are coming under pressure. This conclusion is supported by the fact that a decline in profitability was reported, despite three-quarters of respondents having seen an increase in the value of investment income.

Life insurance

Life insurers report a decline in confidence, with a balance statistic of -36% feeling less optimistic about their business situation. Activity levels continued their positive trends during the quarter, so the weakening of confidence is probably attributable to the stock market fluctuations of early March, continuing growth in the value of contracts being surrendered, and uncertainty over the implications of the proposed National Pension Savings Scheme (NPSS).

In the shorter term, the increase in the value of surrendered contracts reported by a balance statistic of +50% is a very significant development. As some insurers have commented, the growth in surrenders is largely attributable to last year's 'A-day', which has led to transfers of business into SIPP's and a greater degree of churning between pensions. Another factor at work may be customers of the increasing number of closed life funds transferring their business into live funds. In both cases the effect is to depress margins, as demonstrated by the downbeat prediction for the value of new business and the decline in overall profitability reported by a balance statistic of -36%.

Looking to the longer term, December's white paper 'Personal accounts: a new way to save' has clearly had a real impact on the sector's view of its future. When asked to assess the effect of NPSS Personal Accounts on the sector's provision of retirement products, 72% of respondents stated that the proposals would have a 'major impact'. It is also interesting that respondents do not expect to see any change over the next two years, but that

86% expect to feel the effects in three to four years' time as the new scheme comes into effect.

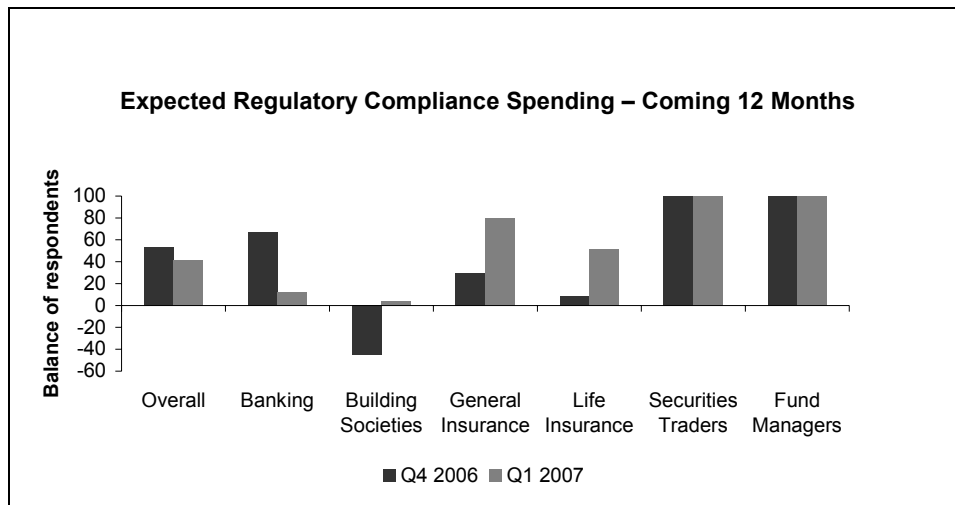
Securities traders

Securities traders report their most confident outlook for a year, with a balance statistic of +40% feeling more optimistic. Most other responses are also upbeat, but it is worth noting that the survey period straddled the stock market turmoil of early March, so the results may smooth over some contradictory responses.

When asked about their levels of business and income during the quarter, traders' responses show a more positive picture than had been predicted at the previous survey. Activity and revenues were seen as having grown for the second period running, in contrast to the cautious predictions made in September and December. Once again though, expectations for the coming quarter are less confident, with volumes and revenue streams expected to level off. It is also noticeable that private individuals are the only customer segment expected to generate more business in the coming quarter. It will be interesting to see if these hopes are fulfilled, given the recent gyrations of the stock market.

In addition to the good levels of activity reported during the quarter, traders' optimism was supported by an apparent absence of margin pressure. The result was that despite having grown its cost base during the period, the sector reported its first improvement in profitability for three quarters. It is also interesting to note that the predicted spike in staff turnover did not materialise, questioning the common perception that spring is the time when City employees bank their bonuses and move jobs. Looking to the coming year, the most notable theme that emerges is that of regulation. For the second quarter running, all respondents expect to spend more on compliance in the coming year and three-quarters see regulation as a major driver of capital expenditure plans. This increase is clearly a response to the approach of MiFID and a fear that over-engineering may drive higher levels of expense. The challenge for securities houses is to engage with the full implications of MiFID whilst avoiding scope creep and ensuring cost effective implementation.

Figure 2: “Spending on regulation and compliance remains a key theme, especially among sub-sectors most exposed to the impact of MiFID”



Fund managers

Confidence in the fund management sector continues to swing between positive and negative results, with a balance statistic of +53% feeling more upbeat than in the prior quarter. This is the most positive result of all the major sub-sectors, and for the first time in several quarters the headline level of optimism seems to fit with the sector's other responses, which are broadly upbeat. Fund managers report a quarter of growing volumes and buoyant income, with the value of fees reported to have grown by a balance statistic of +74%. Levels of growth are expected to cool over the next three months, but this is hardly surprising considering the impending end of the tax year. The fact that activity with all customer segments is also predicted to increase going forward gives the sector further grounds for encouragement.

In terms of the longer term outlook, the sector's response to the recent Pensions white paper is, on the face of it, surprisingly modest. No fund management respondents expect the proposals to have a 'major' impact on their provision of retirement products, only 26% anticipate a 'significant' effect and 60% predict little impact or feel they will be unaffected. These responses may indicate uncertainty over the long term opportunities represented by the white paper, or concerns that any volume growth will be offset by margin pressure. However, the results could also mask contrasting views between retail and institutional respondents, or between larger and smaller fund managers, each of which is likely to have distinct views on the implications of the proposed Personal Accounts.

Encouraged by higher activity levels, fund managers continue to report strong growth in operating costs, with a balance statistic of +87% expecting further expense inflation in the coming quarter. Staffing costs are the major driver, as houses compete for increasingly highly-priced talent. Staff turnover was reported to have grown by a

balance figure of +40%, leading every fund management respondent to report an increase in staff expenses as a percentage of total costs.

Looking to the coming year, fund managers plan to increase their capital expenditure on IT. While improved efficiency remains the most important driver of spending, legislation and regulation now ranks more highly as a reason to invest than at any point in the past year, as the requirements of MiFID and UCITS III become more apparent to the sector.

e-business

Levels of customer e-business adoption continue to advance at the same modest rate seen in recent quarters, with approximately one in four customers at the typical financial services company transacting over the internet. As at the last survey, respondents are expecting adoption rates to tail off, although more than half continue to predict further growth in the total value of internet business.

Underpinning the expected slowdown in growth are the two most persistent barriers to customer adoption, namely preference for other channels and concerns about security and data protection. Security concerns in particular have reached their highest levels since mid-2006, reflecting some embarrassing failures of data security that have received widespread recent press coverage. The problem of 'phishing', has also reached an increasingly wide level of public awareness. This in turn has encouraged the banks to plan upgrades to their online authentication safeguards, although in most cases these improvements have yet to be realised.

With many customers proving reluctant to move online, financial services providers continue to encourage intermediaries to transact with them over the internet. However this too is proving to be a challenge, with the average level of e-business adoption by intermediaries remaining at around one in four for the typical survey respondent. Since the

industry is prevented from using financial incentives to move intermediaries online, they are restricted to offering greater and more easily accessible information via the internet. Even if some financial services companies have been successful at generating business in this way, the survey results suggest that this strategy is not yet delivering rapid growth across the industry as a whole.

About this survey

The survey was carried out between 22nd February and 7th March 2007. A total of 70 companies responded including banks, building societies, finance houses, securities traders, fund managers, commodity brokers, private equity firms, insurance companies and insurance brokers.

If you would like to participate in the survey, please contact Jonathan Wood at the Confederation of British Industry (email: jonathan.wood@cbi.org.uk)

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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