

CBI/PricewaterhouseCoopers Survey

Sharing insights and trends from the financial services industry*

March 2006

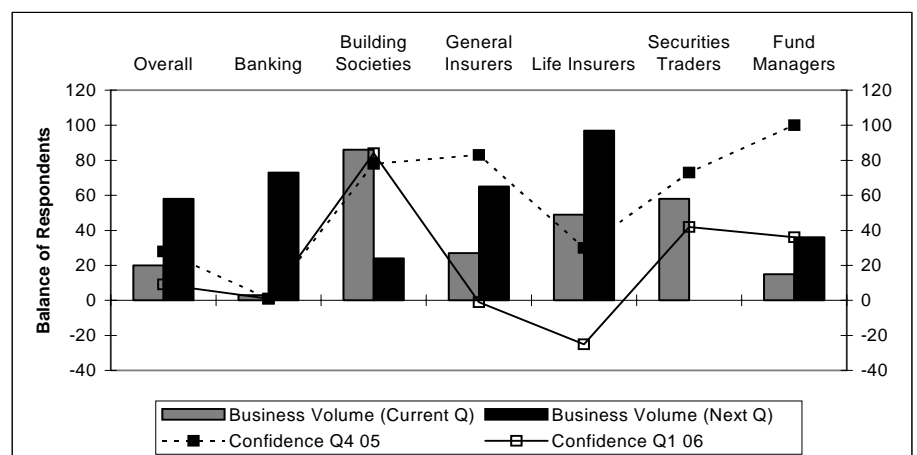
“Although growth in confidence has slowed from December’s exuberant levels, forecasts for volumes of business reach a ten year high”

The 66th CBI/PricewaterhouseCoopers financial services survey shows that the industry remains in an upbeat mood. Although growth in confidence has slowed from December’s exuberant levels, forecasts for volumes of business reach a ten year high. These results imply that the industry is not expecting any major upsets to its operating environment or its ability to make money; on average, profitability levels are forecast to increase. Strangely, several sectors report a significant reduction in optimism despite increasing their forecasts for volumes of business, but this may be a natural ‘cooling off’ after the exceptional confidence levels seen in December.

The industry’s positive expectations for business have a corresponding impact on its employment outlook, with most sectors expecting to increase staffing levels and none predicting a decline in headcount. Reinforcing this impression, the availability of professional staff is now seen as a limitation on business by the highest number of respondents for five years. In such an environment it is unsurprising to find that cost levels are climbing, although per-transaction costs have fallen on average across the industry as business volume growth outstripped cost growth.

Looking forward, financial services companies continue to invest in IT. The need for efficiency remains the greatest priority, but the desire to reach new customers has also reached its highest level for five years. Regulation too remains a driver of capital expenditure; just as some sectors finish a round of compliance-oriented investment, others are entering a fresh regulatory cycle.

Figure 1: “Several sectors report a significant reduction in optimism despite increasing their forecasts for volumes of business”



A balance statistic of +1% of **banking** sector respondents report greater optimism, a steady outlook that reflects the absence of any major changes in the banks' operating environment. Business volumes also remain stable, but the sector is confident enough to forecast fresh volume growth for the coming quarter. Demand from private individuals has been and is expected to remain a key driver, with the bulk of UK consumers continuing to generate good business on both sides of the balance sheet. In contrast, a balance statistic of -19% report a decline in commercial business. This surprising result runs counter to business activity data from the major banks' recent announcements, so it may merely reflect the lowering of expectations after a bumper year in 2005. Fees and commissions out-grew net interest income, with average spreads having unexpectedly declined for the fourth consecutive quarter. It will be interesting to see if this result heralds renewed pricing competition between the banks in 2006.

A majority of respondents are now reporting growth in non-performing loans, with the sector finding that while the number in difficulty remains low by historic standards, those customers that are in trouble have higher levels of debt than in the past. The sector's total costs have climbed but unit costs have fallen, suggesting that the increase was volume-driven. This analysis fits with the reported growth in headcount, as several banks continued to develop their wholesale teams. Despite cost growth, the banks reported steady profitability during the quarter and half are forecasting an improvement.

Looking forward, the sector is predicting further investment in branch networks and IT, with efficiency improvements identified as a priority by 99%. Responses around future prospects suggest that 2006 is unlikely to replicate the highly favourable trading conditions of 2005, but there are few signs that the sector is concerned about its outlook.

A balance statistic of +84% of **building societies** report greater optimism, a remarkably bullish result which even tops the previous quarter's fifteen-year high. With the housing market slowdown apparently over and many property bears revising their valuations upwards, the societies are feeling increasingly relaxed. Strong growth in volumes and revenues were reported, with further expansion predicted for the coming months. Business with private individuals was said to have increased by a balance statistic of +91%, and activity with commercial customers by a balance figure of +53%. This is an unusually high figure, suggesting that a period of strong liquidity within the commercial property sector may be coming to an end. The societies achieved revenue growth in spite of ongoing pricing pressure, with fee income expanding in reaction to margin contraction.

Over three-quarters of respondents reported higher levels of non-performing loans during the quarter. At face value this is a notably negative response which might confirm the fears of property market pessimists. However, it is important to note that the sector's loan losses remain very low, and that the general absence of negative equity means that higher arrears are unlikely to translate into higher write-offs.

The societies continue to report growing staff levels, although given the low employment base of most players, overall increases will remain modest. Even so the growth in headcount is surprising, given that a strong majority of respondents reported reduced cost levels. Profitability has improved and is expected to strengthen further, although the societies remain preoccupied by the outlook for competition and customer demand levels. Despite the fundamentally strong demand for housing in the UK, it may be that some in the sector still fear the potential impact of a property price correction.

The balance statistic for overall business optimism is marginally negative in the **general insurance** sector at -1%. This is a substantial deterioration from the +83% of three months ago and indicates an expectation that profitability is reaching a plateau. There is still optimism on the income side, though not as great as last time; the rating experience over the January renewals, though certainly favourable, looks to have disappointed when set against some optimistic expectations. In December the balance statistic for those expecting to experience a positive trend in the value of commission and premium income over the following three months was +85%, but in the event the balance statistic of those actually reporting a positive trend in income over the period was only +16%. Nevertheless, +54% expect to see a positive trend in premium income over the coming three months. On the costs side there is some pressure emerging on operating costs and, to lesser extent, on claims costs. The balance statistic for the trend in operating costs over the next three months has switched from -55% in December to +22% in March.

The availability of professional staff has become a serious issue with a jump from 13% to 72% in respondents citing this as a factor limiting growth. Within this, the availability of professional staff overseas has become a concern with 31% of respondents (up from 6% in December and 0% in September) identifying it as likely to limit growth. This response probably indicates that operational issues in overseas outsourcing activities are beginning to occupy management. However, previous concerns regarding regulation seem to have virtually disappeared as the flow of regulatory initiatives has slowed. Only 6% of respondents now view this as a factor limiting growth, compared to 73% last time.

Confidence amongst **life insurers** has also deteriorated. The balance statistic for overall business optimism turned negative at -25% compared to +30% last time. In considerable contrast, opinion regarding the volume and profitability of new business is positive. A balance statistic of +48% see a positive trend in the value of new business over the next three months, not very different from the +56% recorded in December. Opinion regarding the volume of new business was virtually unanimous in favour of a positive trend, with a balance statistic of +97%. In principle, these responses would indicate that confidence regarding new business is more than offset by concern around the developing profitability of historic policies written some time ago, and perhaps some longer term worries about the sector. Opinion with respect to older policies probably reflects concern over deteriorating persistency on pensions business, which was mostly written on slim margins anyway. For example projections regarding 'A-Day' usually include some re-broking of existing business, and then a continuing trend towards policyholders consolidating their pension savings from different employments under one wrapper. Also there is ongoing uncertainty about the ultimate outcome of the Pensions Commission proposals.

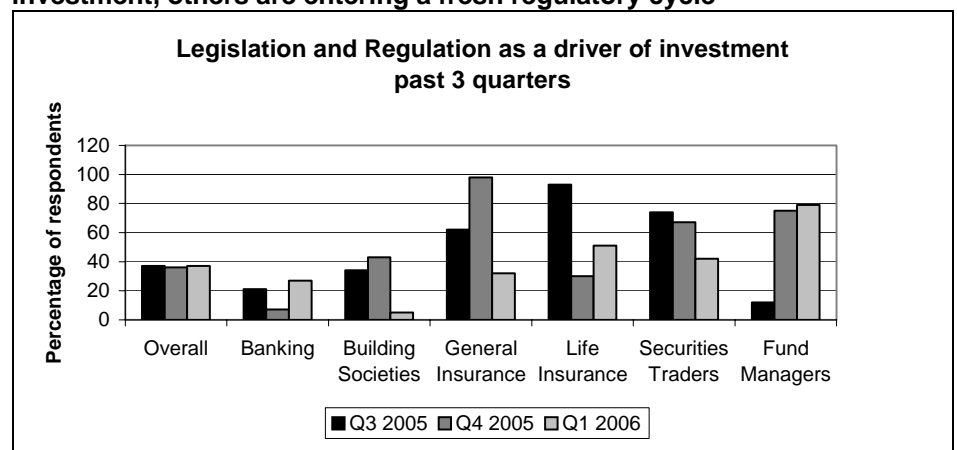
Uncertainty about demand has declined significantly as a limiting factor for capital expenditure. It is cited by only 28% of respondents, down from 75% in December and 100% a year ago. On the other hand the likelihood of an inadequate return on investment limiting capital commitments was cited by 98% of respondents, a jump from 43% last time. An ever clearer view is being demanded of the return on investments, as management attempts to increase returns across the UK industry.

The availability of professional staff overseas is noted as a concern by 25% of respondents, whereas none had indicated this as a concern in any recent period. This most likely reflects outsourced operations beginning to demand some careful management attention.

Securities traders remain confident, with a balance statistic of +42% feeling more optimistic about the general business environment in their sector. Positive trends in activity and results were reported over the last quarter, with business volumes and commission income seen as having expanded by the majority of respondents. The spread of business across customer segments was also encouraging. The balance statistic of +76% reporting more retail activity was the strongest response since the 1990s, reflecting the return of private investors to the markets. Commercial business was also reported to have reached a six-year high. Demand from financial institutions levelled off, reflecting steadier hedge fund activity during the quarter. Despite these encouraging reports, respondents now expect overall volumes of business to flatten out. There may be a realisation that activity levels in some markets have been buoyed by volatility, and that this is unlikely to continue into the coming quarter.

Securities traders have allowed their total cost base to increase to support the increase in activity. This growth continues a trend for increased activity to boost confidence, leading to recruitment across the business. With activity growth continuing to outpace cost inflation, unit costs and profitability improved during the period. However, for the first time in over two years traders are forecasting that total costs will be trimmed. This change of view confirms the impression that traders are expecting to move from an expansion model to a more stable environment, where expense control will become a more important lever. Profitability has improved but like volumes, income and costs it is expected to level off in the coming quarter. Declining intentions for capital expenditure reinforce the impression of caution, although given the approach of the Markets in Financial Instruments Directive (MiFID) it is surprising to see that regulatory-focused investment is expected to fall. In terms of business prospects, traders are twice as worried about demand levels as they are about competition. This reflects the sticky nature of customer relationships in the brokerage business; in most sectors covered by the survey the two issues tend to be closely linked.

Figure 2: “Just as some sectors finish a round of compliance-oriented investment, others are entering a fresh regulatory cycle”



A balance statistic of +36% of **fund managers** report greater optimism, a positive response but one which seems cautious in comparison to the more exuberant preceding two quarters. The key figures for business volumes and the value of income grew, but at a slower rate than might be expected during an ISA season, especially at a time of strong asset inflows across the industry. For instance, the balance statistic of +15% that report higher volumes looks surprisingly low when climbing equity values and heavy investment in company pension schemes are taken into consideration. Retail business is reported to

have increased, but only by a balance statistic of +36%; in the current operating environment this is another surprisingly cool response, and could be partly attributable to a lower level of survey responses.

On the cost side, there are indications that the growth in business volumes and asset values have encouraged fund managers to take their eye off expense control. All respondents say that their total cost base increased during the quarter, and that it will continue to climb in the next three months. The major driver of this growth has been staffing increases, which 100% of respondents expect to continue into the coming quarter. In fact, expense growth has been steep enough to halt profitability improvements for the first time since the current equity market recovery began. Nonetheless, fund managers appear confident when asked about their investment intentions, continuing to plan more marketing expenditure and greater levels of capital spending on IT. While the need for greater efficiency remains the primary driver of IT investment, the goals of providing new services and serving new customers have also jumped notably. Regulation too remains a priority for the sector, with 79% of respondents expecting to spend in this area as the deadline for compliance with MiFID draws closer.

e-business

Internet use continues to expand among financial services customers. However, while the overall value of internet business is growing at an ever-stronger rate, this does not reflect expansion in the proportion of customers using web-based services. Respondents say that on average 16% of their customers use the internet to transact; this figure has hardly changed over the past few quarters and is only predicted to reach 18% in twelve months' time. So the growing value of internet business is not attributable to faster internet adoption, but to the one-sixth of customers that already transact online making greater use of web-based services.

The explanation for slow adoption is found in the reported barriers to e-business development. Speed and accessibility of the internet in the UK may be improving (for example, the latest DTI Information Security Breaches survey reveals that 85% of UK businesses are now on broadband), but it is customer preferences that remain the greatest obstacle to growth. In several cases customer-related barriers are actually seen as growing; for example, the proportion of respondents who think customers prefer other channels jumped from 40% to 58% during the quarter. This leap probably reflects recent media attention on identity theft, illustrating the kind of problems that financial services businesses face in trying to convince customers to use web-based services.

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 21st February and 8th March 2006. A total of 79 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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