

CBI/PricewaterhouseCoopers Survey

Sharing insights and trends from the financial services industry*

June 2006

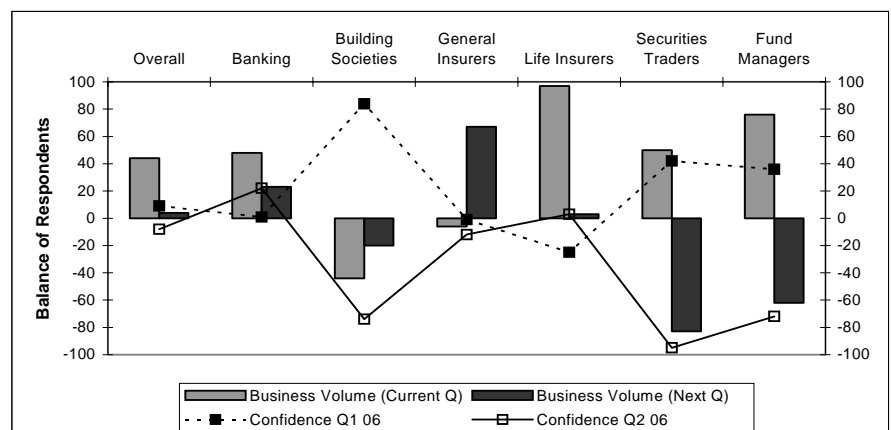
“The overall set of results are far from poor... There seems to be good reason to believe that the overall dip in confidence may prove to be short-lived”

The 67th CBI/PricewaterhouseCoopers financial services survey shows a slight decline in the industry’s level of confidence after several quarters of positive sentiment. However, the overall picture is not particularly helpful since there is wide variation between sub-sectors, with several groups of respondents showing marked negative swings in sentiment. Among the sectors experiencing a drop-off in confidence, the major driver of change has been recent falls in the equity markets. Given that equity values remain at year-end 2005 levels, it seems possible that the dip in sentiment may represent a short term over-reaction. Furthermore, other sub-sectors - most notably the banks and life insurers – are feeling increasingly confident about their business environment.

Despite the decline in headline confidence overall employment trends remain positive, with most major sectors expecting either to maintain or expand their staffing levels in the coming quarter. The industry’s total cost base is expected to continue its controlled expansion, with marketing spending continuing to grow. Even so, average costs per transaction and overall profitability are predicted to remain steady over the coming quarter.

The industry also appears upbeat in terms of its capital expenditure plans. In particular, IT investment intentions reach their highest level for eight years. Although regulation is once more a growing driver of investment for some sectors, it is also notable that the desire for more capacity reaches the highest level yet seen in the survey. In summary then the overall set of results are far from poor, despite the gloom of some respondents. There seems to be good reason to believe that the overall dip in confidence may prove to be short-lived.

Figure 1: “There is wide variation between sub-sectors, with several groups of respondents showing marked negative swings in sentiment”



A balance statistic of +22% of **banking** sector respondents report feeling more optimistic during the quarter. This is the most positive response for over a year, and shows that the banks remain confident despite some changes in their operating environment. Volumes continue to look solid, with strong savings activity and steady mortgage demand offsetting a slowdown in unsecured lending. Business with private individuals is holding up well, but commercial business is reported to have declined for the second quarter running. The banks gave no indication of concern about their commercial business in their recent trading statements, but that is sure to alter if certain areas of the economy are indeed approaching troubled waters. Another change in the banks' environment is in the area of spreads, which continued their four-year decline. This was probably due to a shift in lending mix rather than any renewed pricing competition, and a small positive balance are now hoping that potential interest rate increases might offer the chance to stabilise or even expand their interest margins.

On the cost side, the banks continue to oversee a careful programme of investment. Total expenses climbed during the period, but positive operating leverage was maintained and profitability increased for the fourth consecutive quarter. Growth in the value of non-performing loans continued, although problems are still largely confined to the unsecured segment, as discussed in the recent PwC report 'Living on Tick: The 21st Century Debtor'.¹ Credit trends for secured and commercial lending remain relatively benign.

Looking forward, the sector retains an optimistic stance, with marketing spend reported to have grown strongly and IT investment intentions reaching a seven-year high. It is a further reflection of the banks' confidence that 75% plan to invest in expanding capacity, and that increasing numbers are concerned about the potentially limiting effects of staff availability.

A balance statistic of -74% of **building societies** report feeling more pessimistic about their business situation, a dramatic swing from the strong optimism of the prior quarter. Volumes of business and the value of income are reported to have fallen; further declines are predicted and business with retail customers is said to be on a downward trend. Although there have been some reports of slowing activity in the mortgage market recently, nothing has yet emerged that would fully explain these surprising results. One explanation could be disappointment, given that growing volumes had been predicted at the prior quarter. Another factor could be concern about the potential effect on mortgage volumes of any rise in interest rates; if so, this would be consistent with the sector's prediction of an increase in average spreads. The societies may also worry that they are yielding market share to the banks, which continue to target the mortgage and savings markets aggressively.

Despite their pessimistic predictions, the societies continue to report increasing levels of headcount, and costs have begun growing again after two quarters of unusually careful control. Furthermore, staff levels, marketing spend and total levels of expenses are all predicted to increase over the summer months. Levels of non-performing loans continue to grow, but expansion is slow. Strong levels of equity in the housing market mean that climbing arrears are only translating slowly into non-performing loans. Another encouraging result is that IT investment plans have rebounded strongly, with a balance figure of +94% planning to spend more in the coming year. Regulation has re-emerged as a driver of investment, as many in the sector reach the IT implementation stage of Basel II. Finally, it is notable that the societies are becoming more concerned about the availability of professional and clerical staff. This is another response that suggests the sector may not be feeling quite as pessimistic about future growth as the headline data implies.

¹ Living on Tick: The 21st Century Debtor, May 2006 (www.pwc.com/uk)

Confidence in the **general insurance** sector has deteriorated a little during the period, with the balance statistic for business confidence dipping to -12% from -1% in March. This continues the more negative outlook established in the prior quarter, when confidence fell from the +83% figure in December 2005. Volumes of business within the major customer segments are expected to change little, but there is continued upward pressures on operating costs, which a balance of +18% of respondents expect to increase.

The claims environment is turning out better than expected, with a balance statistic of -5% for the actual value of claims over the past three months, compared to a prediction of increased claims costs in the previous survey. The result is that the trend in overall profitability is essentially flat, where the expectation in March had been negative. The better than expected claims experience will have been a positive surprise for the sector. Whilst claims costs are not expected to be disruptive in the near term, the medium term sustainability of the current benign claims environment must be fragile at best.

The provision of new services has become a far more important goal of capital expenditure, being cited by 88% of respondents compared to just 22% in the previous quarter. At the same time, uncertainty about demand and business prospects is cited as a limitation on investment by 94% of respondents. It would be unusual for the number of policies to be very variable, so presumably this response relates primarily to negative outlook for premium rates. Concerns over the impact of competition are cited by 96% of respondents, which adds to the impression that the general insurance market has probably passed its peak levels of profitability during the last six months.

Insurance brokers show a trend of increasing demand from the corporate sector and reducing business with individuals. As regards the corporate sector, the underlying demand for brokers' services is clearly robust despite the wider threats posed by factors such as disintermediation and the 'Spitzer'-related changes to business practice. On the individual customer side, the results show that brokers are currently losing business to the direct and banking channels.

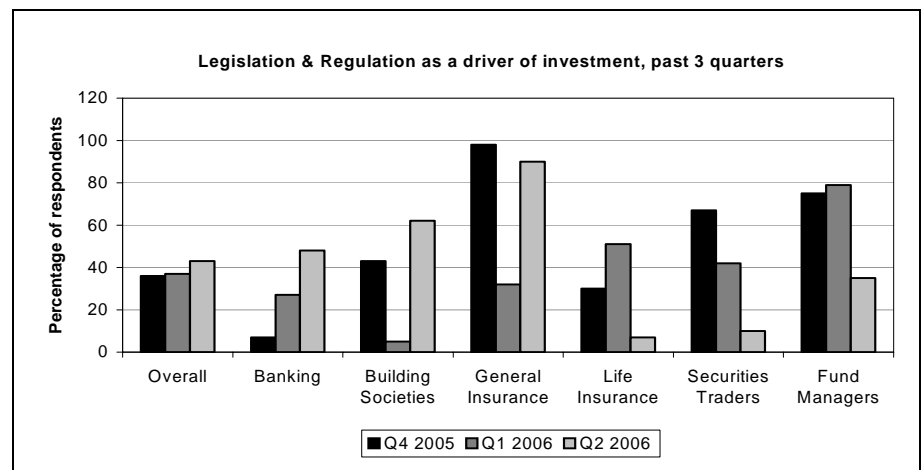
Confidence amongst **life insurers** has recovered to a positive balance figure of +3% during the period. There is a clear message that the volume and value of new business has trended upwards, particularly among corporate customers. A balance statistic of +95% say that the value of new business increased during the quarter, and a figure of +97% report that corporate business is on an upwards trend. This is consistent with the current themes of corporate pensions restructuring and greater contributions from existing members, with the sector well-placed to benefit from increasing flows into defined contribution arrangements. It is therefore notable that the balance statistic for overall profitability is neutral at +2%, suggesting there are some pressures on the profitability of the in-force book. One driver of this pressure is likely to be deteriorating persistency, as some policyholders switch away from older, less attractive/efficient and perhaps higher charging policies towards newer products. Cost pressures are probably another factor, since staff costs are said to be on an upward trend by a balance of +95%, up from -2% at the last quarter, and 95% of respondents see the availability of professional staff as a constraint on growth.

There is evidence of an increased focus on product development; 97% of respondents (up from 49%) are expecting to invest capital in the development of new services. Pensions 'A-Day' is no doubt a factor here, along with the development of SIPPS and Wrap products. There is also ongoing development work aimed at incorporating guarantees in to unit linked products so that they might more fully occupy the space once taken by with-profits. At the same time, attempts are being made to revive the with-profits product itself.

Securities traders report a marked decline in sentiment. A balance statistic of -95% are feeling less optimistic. This is the lowest figure reported since 1998 and compares to a balance figure of +42% at the last quarter. This sudden change is driven by fear that recent falls in equity values will lead to weaker underwriting revenues and trading commissions. Although the outlook for business with private individuals has reached a three-year low, the key factor behind the gloom is the concern that the flow of new issues to the market is unlikely to continue in tough market conditions. The LSE was able to boast that it had brought over 600 new listings to the UK market in the year ended March 2006; whilst many of these were AIM listings, the Main Market still saw the addition of over 100 new entrants including 18 from overseas. This has helped securities houses to generate significant advisory and underwriting fees, as well as ongoing trading activity. Any slowdown in the flow of new issues will have an immediate effect on fee income, with the further possibility of long term reductions in commissions if trading volumes decline. Respondents' pessimism about the coming quarter shows how vital public offerings are to many areas of this sector's business.

In contrast to the gloomy outlook, securities houses reported increased profitability, with solid revenue trends offsetting the effects of higher costs. Cost growth is now expected to level off in the coming months, but even so the effect of falling revenues is expected to erode profitability. In this uncertain environment it is particularly notable that a majority say that they plan to increase headcount, although staff increases could be focused on areas of business unaffected by equity trends. When asked to consider their outlook for the coming year, traders show further signs that their confidence has taken a serious hit: Marketing spend is expected to contract sharply, and investment intentions are down. Uncertainty over business prospects is also cited as a reason for caution by 90% of respondents.

Figure 2: "Regulation is once more a growing driver of investment for some sectors"



A balance statistic of -72% of **fund managers** report feeling less confident, with the falling equity market driving a strong swing in sentiment from the prior quarter's cautious optimism. All the key responses relating to business volumes, income streams and customer activity tell a story of strong business during the quarter but contrastingly negative predictions for the coming months. A typical response relates to levels of commission income: A balance statistic of +83% report growth during the past three months, but a figure of -69% predict contraction in the coming quarter. Considering that the UK equity market has so far fallen back only to December 2005 levels – at which point sector confidence was strong – these results look like something of an over-

reaction. One reason for the strength of negativity may be fears that private investors, whose confidence has been slowly rebuilt after the last bear market, will be scared away permanently. The potential impact of higher interest rates on profits and spending could also be a lesser factor.

The sector's cost base continued to climb during the period, but strong income growth enabled almost all respondents to improve their profitability. However, any fall in income is expected to drop directly to the bottom line and a balance figure of -48% now predict that profits will decline. This is a sector which tends to find it hard to flex its cost base in the short term, so management are unlikely to target major cost reductions unless they are convinced they face a prolonged market downturn. Even then, expense savings could be hard to find as the sector has already achieved significant improvements in back office efficiency. So far there are no signs of panic, with a balance statistic of +83% planning to increase IT investment and marketing costs also expected to grow. These results offer some hope that the sector's underlying sentiment may not be as depressed as the headline figures suggest.

e-business

Use of the Internet appears to be growing faster than ever and financial services companies remain very confident that growth will continue in the coming year. In the past growth has been largely fuelled by existing web users transacting more, rather than by new web users. However there are now signs of increasing Internet adoption among customers. For the first time, more than a quarter of respondents' customers are now using the web to carry out transactions; this is considerably higher than last quarter. Respondents expect this surge in adoption to continue, predicting that over a third of their customers will be using the web to transact in a year's time. Even so, there remains a huge amount of variation between companies. Among the top quartile, more than half of customers use the web to transact; in the bottom quartile, less than 10% of customers do so.

Convincing customers to transact online continues to be the major obstacle to Internet adoption, dwarfing the other barriers to e-business. There has also been a big rise in customer concerns about security and privacy, which now rate almost as highly as customer preference for other channels. The April 2006 DTI information security breaches survey² highlighted the increasing number of security breaches at UK businesses, and other research has shown that many private computers are infected with viruses or software that spies on confidential information (so-called spyware). Banks in particular are starting to respond to these concerns by providing customers with free anti-virus software and online identity tokens. The security arms race is hotting up at a critical time for e-business adoption.

² DTI Information security breaches survey 2006 (www.dti.gov.uk)

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About this survey

The survey was carried out between 25th May and 7th June 2006. 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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