

## CBI/PricewaterhouseCoopers Survey

December 2005

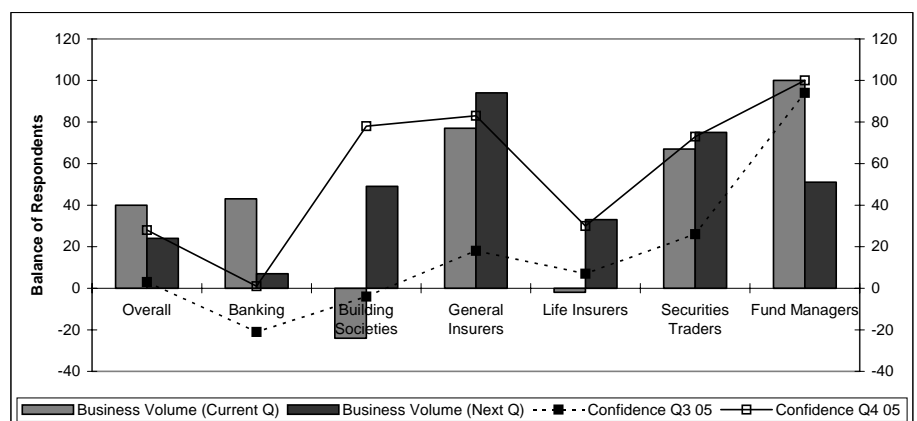
**“All major sectors report improved sentiment, and several reach their highest levels of optimism for some years”**

The 65<sup>th</sup> CBI/PricewaterhouseCoopers financial services survey shows the industry growing in confidence. All major sectors report improved sentiment, and several reach their highest levels of optimism for some years. The increase in positive sentiment is driven by overall growth in business volumes and revenue streams; most sectors report greater activity and all expect to do more business in the coming quarter. Another key factor is the increase in activity experienced across all customer segments, which is also predicted to continue. The upbeat picture is underpinned by an encouraging environment of low real interest rates, steady house prices and rising equity markets, with retail credit quality the only area of potential concern.

Reflecting their expectations of growing activity, many sectors have allowed costs to rise. The largest single factor behind this growth has been a strong increase in hiring, which is forecasted to continue, albeit at a slower rate. Nonetheless, per-transaction costs remain on a downward track and the reported increase in industry profitability is the strongest seen for almost a decade.

In terms of capital expenditure, the industry plans to carry forward the patterns of 2005 into the coming year. IT is the main focus of investment, with efficiency improvements the clear priority as companies aim to benefit from higher business volumes. It is noticeable that spending on property remains a priority for some but not all sectors. Regulation is a persistent concern, with fund managers newly preoccupied by the costs of compliance.

**Figure 1: “Most sectors report greater activity and all expect to do more business in the coming quarter”**



In the **banking** sector, respondents' sentiment is essentially unchanged from the prior quarter, with a balance statistic of +1% feeling more optimistic. This balanced viewpoint tallies with recent trading announcements reporting steady income growth and controlled costs but rising loan arrears. Survey responses indicate that demand from private individuals is barely growing, but that commercial activity is more buoyant. A strong pick up in business with financial institutions is reported, possibly reflecting high levels of activity among securities traders. The banks are also enjoying stronger fee income, as they try to compensate for the effects of interest margin erosion. Although the decline in average spreads is said to be slowing, margins remain under pressure and the reported growth in interest income can only be attributable to higher average loan balances.

The most striking result from the banks is that a balance statistic of +41% report an increase in non-performing loans, with further growth predicted. This is the highest level since 2002, when corporate lending write-offs peaked. Now it is consumer lending driving loan provisions, while corporate arrears are at record lows. UK personal borrowing remains at historic highs, and while most individuals are servicing their debt a growing minority now seem to be getting into financial difficulty, as reflected in the recent trading updates of listed banks. Respondents say that operating expenses were kept under control during the quarter, and that this will be maintained going forward. Therefore the balance statistic of -28% who expect profitability to fall in the coming quarter (the most pessimistic result since 2000) are probably reflecting concerns over sub and non-prime consumer credit trends.

Investment patterns portray a contrast between banks' front and back offices. Numbers employed have grown, driven by customer-facing staff, and property spending on branch improvements is also expected to expand. Even so, headcount is now predicted to fall as back office cuts take effect, and banks' IT investment plans are increasingly motivated by efficiency (99%) and replacement (71%).

A balance statistic of +78% of **building societies** report feeling more optimistic than in the prior quarter, a stunning improvement on recent results and the highest figure recorded in 15 years of the survey. The sector has renewed expectations of volume and revenue growth, and fresh hopes for business with private individuals. These upbeat forecasts are based on industry statistics suggesting that mortgage approvals are increasing and that the slowdown in house price growth reversed during the third quarter. Despite those encouraging signs, the exceptional level of optimism is surprising given that business volumes and average spreads are both said to have declined during the period.

In terms of non-performing loans, the societies seem to be faring better than the banks. Although mortgage arrears have risen slightly the quarterly change is small, and the balanced response is that the situation will not change in the coming three months. This lends weight to the view that current retail credit problems are concentrated in consumer credit, where the societies are likely to be less exposed than the banks.

The societies report that costs were kept controlled and that profitability improved during the period, despite staffing levels having increased for the third consecutive quarter. However, plans for further headcount expansion mean that renewed cost growth and downward pressure on profitability are forecast. The sector also continues to invest in its infrastructure, with a balance statistic of +80% expecting to increase capital spend on IT in the coming year. This investment is motivated by a desire to expand capacity as much as by a need for greater efficiency, confirming the sector's confident outlook.

A balance statistic of +83% feel more optimistic in the **general insurance** sector. This is a substantially more positive view than three months ago when the figure was only +18%. The rating outlook has improved since Katrina and other US hurricanes, in the context of what had been a softening market. This is supported by the jump in respondents seeing an uptrend in commercial business over the past three months, from 0% in September to a balance statistic of +79% in December. The figure for private individuals has also jumped from zero to +50%, and there is a strongly positive view of the trend in investment income. Another area experiencing positive trends is operating costs, where a longstanding trend for efficiency-focused capital expenditure may be starting to have an impact. Total operating and per-transaction costs have both moved from growth in the prior quarter to reductions in the current period. It is notable that claims costs are not seen as an issue at present; only very low balance statistics are recorded regarding expected trends.

As regards capital expenditure, the focus continues to be on IT spending, with efficiency gains having helped to reduce occupancy costs. In a notable change, shortage of labour is now seen as a factor limiting capital expenditure by two thirds of respondents. The main objectives of capital expenditure continue to be efficiency and regulatory needs, cited by 100% and 98% respectively, with few respondents prioritising new services or new customers. General insurers also remain primarily constrained by competition and regulation rather than demand. Finally, the outlook for brokers' business volumes shows considerable divergence between commercial clients, where a balance statistic of +41% see an improving trend, and private individuals, where pressure on the high street broker has left a balanced figure of -31% seeing a deteriorating trend.

Confidence has improved amongst **life insurers** with a balance statistic of +30% now feeling more optimistic. This is primarily based on expectations of volume and efficiency gains. For example, although respondents took a neutral view of business volumes during the quarter, a balance statistic of +33% predict greater activity in the next three months. There is some optimism around next year's 'A-Day' of pensions simplification, and in recent months this has increased the sales of SIPPs. Improved investment markets also tend to have a lagged effect on new business for individual savings products, and this may be felt in the coming quarter. Despite these positive factors, there could however be some negative reaction to the withdrawal of expected permission for residential property to be invested within SIPPs. The Turner Report could also affect the outlook, since it may be seen as diminishing life insurers' role and profitability in the pensions market. Nonetheless, the final form in which Turner will be implemented is subject to considerable debate.

Operating costs are the other major positive influence on the sector's sentiment. A balance statistic of -38% of respondents expect average costs per transaction to fall in the coming quarter, although deteriorating persistency may be a concern; a balance statistic of +30% predict growth in the value of surrendered contracts with less than two years' duration.

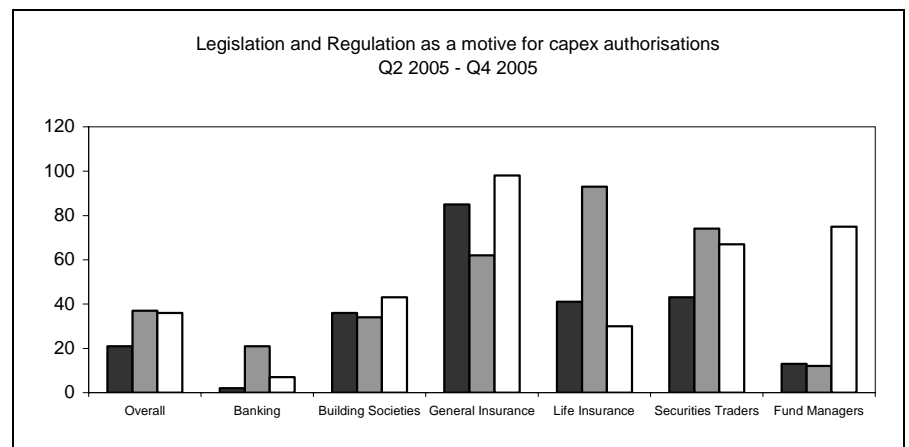
Product development is becoming more of a feature as the industry responds to changing patterns of demand, 'A-Day' and increased competition for savings. A figure of 72% of respondents - up from 26% - cite new services as an objective of capital expenditure. The availability of suitable staff is seen as a constraint on future development by over half, as in the prior quarter. Perhaps surprisingly, the ability to raise funds also reappears as a limiting factor. This may reflect an increasing likelihood that groups will find their available UK returns unattractive in a global context.

**Securities traders** are growing ever more confident. A balance statistic of +73% feel more optimistic - the highest level recorded since 1998 - and more

than two thirds of respondents report higher business volumes and stronger commission income. Traders benefited from high levels of volatility during the quarter, triggered by worries over the impact of hurricanes in the Gulf of Mexico on oil prices. Additionally, share buy-backs by blue chips have boosted the level of cash circulating between investment managers, traders and bankers. Despite these exceptional features, strong activity is predicted to continue, with an expected upsurge in retail activity identified as the driver. A balance statistic of +58% anticipate doing more business with private individuals in the coming quarter. This is the highest figure in five years and may signal the return of retail investors' confidence as they look for yield beyond property.

The sector has seen its operating costs grow for the second quarter running, and the trend is expected to accelerate. In such a people-driven business, strong hiring is the key driver of expense growth. A balance statistic of +84% say that staff were added during the quarter, and this is predicted to drive up training costs in the coming three months. Even so, the expansion in costs did not prevent a majority of respondents from reporting improved profitability. Looking to the coming year, traders will maintain their focus on marketing spending and three-quarters plan to expand their capital expenditure. Their aim is to improve efficiency through a stronger and more scaleable IT infrastructure that will permit expansion while reducing running costs. Despite their bullish outlook, it is noticeable that all respondents are concerned about potential limitations on demand. This suggests that the sector's growing confidence could all too easily be undermined.

**Figure 2: "Regulation is a persistent concern, with fund managers newly preoccupied by the costs of compliance"**



**Fund managers** answering the survey all report greater confidence, giving a balance statistic of +100%. Although the level of responses was not as strong as normal, this positive view fits with the previous quarter's picture and is consistent with the outlook for the sector as a whole. Asset inflows remain positive, driven by a combination of equity market gains, a cooling property market, corporate pension scheme deficits and low real interest rates. Business activity is also reported to be growing across every customer segment, and all respondents say that commission income and overall business volumes have grown. Fund managers are reacting to growth by expanding their staff and training budgets, with all those answering the survey expecting to add to headcount in the coming quarter. The unsurprising result of this is that costs are climbing, but in their confident mood most fund managers predict that the sector will continue to improve its profitability.

Fund managers continue to plan higher IT expenditure, in anticipation of greater volumes from new and alternative products. Concerns about the

potential impact of falling demand have fallen notably, reflecting the sector's mood-driven views. Even so, there are two unexpected results. Firstly, the balanced expectation for marketing in 2006 is flat. Given that the last quarter of the tax year is approaching this looks surprising, although the response could reflect an institutional bias among respondents. Secondly, regulation is cited as a driver of capital spending by 75% of respondents. This is a steep climb from recent levels, and may be attributable to greater awareness of the potential impact of MiFID on the sector. Overall, fund managers are bullish on their outlook; but recent announcements of company pension schemes withdrawing from equities in favour of bonds, derivatives and alternative products will be a reminder that current growth levels may be hard to sustain in the longer term.

## e-business section

Customer use of the Internet is continuing to rise; roughly a fifth of the average respondent's customers now use the Internet to carry out transactions. What is interesting is how accurate the predictions companies made a year ago have been. A year ago, 40% of respondents forecasted that more than 21% of their customers would transact over the Internet by now; and 39% of respondents report those customer levels today. If predictions remain this accurate going forward, we can expect roughly 20-25% growth in customer uptake over the next year, similar to actual growth rates achieved in the past.

The two biggest obstacles to greater growth remain customer concerns about security and customers' preference for other channels. Concerns over security have shown a small decline after the phishing-related climb during 2005. Possibly explaining this are banks' plans to trial the use of hardware tokens for Internet banking customers, technology that should reduce the risk from key logging viruses and phishing attacks. However, respondents are not expecting any great sea-change; looking forward a year, the same two obstacles stand out.

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:

Katie Ryalls  
PricewaterhouseCoopers  
Southwark Towers  
32 London Bridge Street  
London SE1 9SY

or send an email to:  
katie.ryalls@uk.pwc.com

PricewaterhouseCoopers ([www.pwc.com](http://www.pwc.com)) provides industry-focused assurance, tax and advisory services for public and private clients. More than 120,000 people in 139 countries connect their thinking, experience and solutions to build public trust and enhance value for clients and their stakeholders.

(Unless otherwise indicated, "PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP, a limited liability partnership in the United Kingdom. PricewaterhouseCoopers LLP is a member firm of PricewaterhouseCoopers International Limited each of which is a separate and independent legal entity.)

### About this survey

The survey was carried out between 21<sup>st</sup> November and 2<sup>nd</sup> December 2005. 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.

### 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](mailto: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 Katie Ryalls, PricewaterhouseCoopers on 020 7212 3277.

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

John Hitchins

### Building Societies

Peter Jeffrey

### Capital Markets

Phil Rivett

### Fund Management

Pars Purewal

### Insurance

Clare Thompson