

## CBI/PricewaterhouseCoopers Survey

March 2004

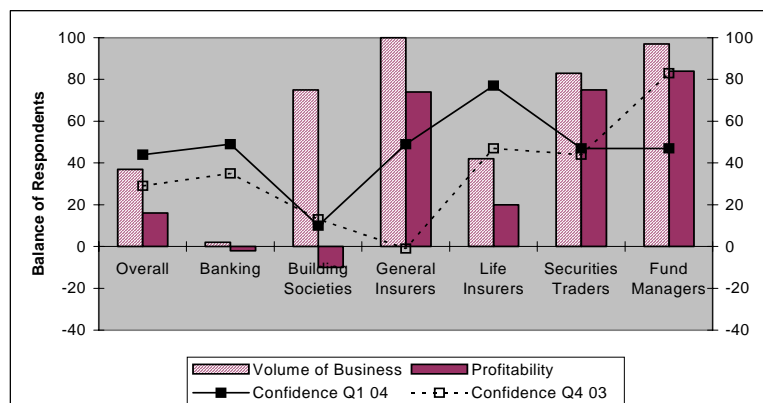
**“Respondents reached their highest overall level of confidence since 1999.”**

The 58<sup>th</sup> CBI / PricewaterhouseCoopers financial services survey provided further evidence of the industry’s recovery, as respondents reached their highest overall level of confidence since 1999. Different sectors reported disparate levels of growth, as some experienced a rebound, while others that have weathered recent periods well – such as banking - continued on an even keel. Business expanded across all customer segments, with private individuals remaining the key area of growth. All types of income increased, reflecting the positive impacts of higher interest rates and rising equity markets. Notably, average spreads increased for the first time in two years.

On the expense front, increasingly confident respondents were willing to match higher volumes of business with increased expenditure. Total costs increased in line with expectations, with higher marketing spending and increased headcount a factor in many sectors. Further hiring is expected by the largest balance of respondents since 2000, as companies re-recruit many whose roles were removed during the bear market. Nonetheless, increased volumes were sufficient to reduce the average level of costs per transaction and deliver the fourth successive quarter of increased profitability.

The industry is expecting to spend more on IT in the coming year, with the goals of handling higher volumes, improving efficiency and reducing processing costs. Levels of demand and competition remain the factors thought most likely to limit business development, but worries over legislation and regulation have also reached their highest ever level. The regulation of mortgage and general insurance sales contributed to the change in mood, but concerns over greater scrutiny of life insurers and fund managers also played a part.

**Figure 1: “Different sectors reported disparate levels of growth, as some experienced a rebound.”**



A balance statistic of +49% of **banking** respondents felt more confident during the quarter, reflecting continued optimism in the sector. Although volumes of business did not grow as fast as expected, the overall picture is

one of steady growth with expansion forecasted to continue strongly. Banks benefited from increases in interest rates; average spreads were reported to have increased by a balance statistic of +25%, the highest jump in over a decade. Private customers remain the sector's engine of growth, despite media speculation over consumer debt levels. In contrast, business with commercial customers fell, but respondents seem unconcerned, with the majority forecasting a recovery for this segment. The banks have held costs flat, and indicate a renewed determination to reduce expenses. Nonetheless, while headcount fell in line with predictions, further staffing reductions are not expected. Surprisingly, despite higher revenues and lower costs, profitability was reported to be flat.

On the investment front, there are signs of mixed sentiment. After a slight increase in the previous quarter, investment in IT is now expected to fall. This might seem surprising, given current spending on regulatory compliance, but may indicate that IT departments are already working at capacity. The fact that regulation is not cited as an investment driver reinforces this impression. More positively, the need to expand capacity is cited as a reason for capital expenditure by 71% of respondents, an unusually high level. Looking to the future, legislation and regulation are seen as a threat to business development by 49%, the highest level for two years. This indicates concern that the implementation of mortgage regulation, IFRS and Basel II in quick succession could divert management attention from other priorities.

After the previous quarter's return to optimism, a balance statistic of +10% of **building societies** feel more confident, bringing a welcome impression of stability. Volumes of business continue to increase, aided by the strong housing market, and private custom was reported to have grown by a balance statistic of +80%. Less positively, the sector is still exposed to very strong mortgage competition, with the effect that average spreads reduced for the twentieth consecutive quarter, despite the upward turn in interest rates. Margin pressure is expected to persist as back book re-pricing continues to bite. Another factor is the rising cost of funds, with mortgage volumes outstripping deposit inflows forcing the societies to compete more intensely for deposits or rely on wholesale funding. The sector has expanded its headcount, a trend expected to continue as processing needs grow. Reflecting this, total costs rose notably, although high volumes reduced costs per transaction. Credit costs remain negligible, but margin pressure was sufficient to depress profitability.

Despite the competitive environment, the sector is confident enough to invest in future growth. Marketing spend is forecasted to climb for the eighth consecutive period, while a balance statistic of +35% expect more capital expenditure on IT. Replacement is seen as a key reason to invest, with respondents aiming to relieve the strain on infrastructure and improve efficiency. The introduction of mortgage regulation is another factor driving spending; and the compliance burden also appears as a factor limiting business development. The availability of funds is seen as a threat by 30%. This is the highest level in seven years, another sign of the impact on the sector of an increasingly competitive deposit market.

**General insurance** has moved to a strongly positive outlook, with a balance statistic of +49% feeling more optimistic. This is the most upbeat result in five years, reflecting growing volumes of business across all customer segments. Personal lines emerge as a particularly strong area, which might be explained by the impact of modest rate increases. There was also increased business reported with commercial, financial and overseas customers; the last group was reported to have increased its activity by a balance statistic of +24%, another five-year high. These positive trends are expected to

continue, with the sector confident that it can generate growth going forward. General insurers also converted volume into value, with premium income and investment revenues reported to have grown. The sector is feeling sufficiently confident to permit cost inflation - a rapid expansion in numbers employed was another surprising result. However, a reduction in costs per transaction led to a strong reported increase in profitability.

The optimism of general insurers shows through in their investment intentions, with a balance statistic of +49% planning to increase IT spending. Improving efficiency is a motivation to invest, but providing new services and reaching new customers were also cited by 74% of respondents. A shortage of professional staff also implies confidence, as the sector reverses some of the headcount reductions of recent periods. Given these positive indicators, plans to keep marketing spending flat seem surprising. Considering their outlook, general insurers are concerned about statutory legislation and regulation, as they contemplate the regulation of their sales activities.

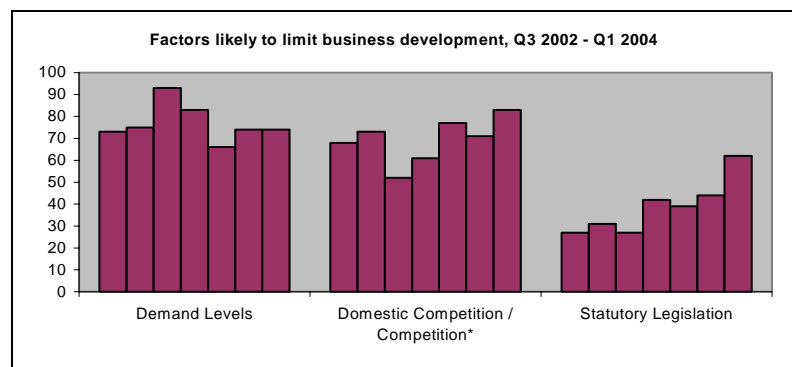
The **life insurance** sector is increasingly optimistic, with a balance statistic of +77% feeling more positive. After the previous quarter, when sentiment appeared to have moved ahead of reality, optimism was supported by strong reported increases in volume. Life companies increasingly believe that demand will rebound as customers address their long-term savings needs, and it was notable that business grew across all customer segments for the first time in three years. Increases in the value of all types of income imply that the sector's efforts to improve its product range and profitability measurement are bearing fruit. Confidence may also have been enhanced by a perception of improved relations between the life companies and government. Profitability increased, but a less positive feature was a rise in the value of contracts surrendered within two years. This was reported by an unusually high balance statistic of +20%, suggesting either that mis-selling has taken place, or that negative publicity has caused policyholders to walk away. Neither explanation is likely to enhance the life companies' outlook.

The sector was one of the few to reduce its overall costs during the quarter, with a strong decline in headcount indicating that the pattern of cutbacks seen in 2003 is continuing. Investment in IT continues, and appears to be contributing to improvements in efficiency. Despite the introduction of straight through processing by some life companies, the sector is expecting further spending on STP, as well as on consolidating legacy systems at merged companies. Reviewing its future prospects, life insurers appear less confident. Levels of demand, competition and the threat of regulation are all identified as a concern by 79%. Regulation is a particular worry at present, reflecting the number of new FSA consultation papers focusing on capital matters.

A balance statistic of +47% of **securities traders** reported feeling more optimistic, marking the fourth consecutive quarter of improved sentiment. Further increases in stock market values and trading volumes were the key drivers. The results confirm the view that private investors have returned to the market; business with other customer segments also increased. Traders managed to grow their commission income in line with volumes, with further expansion expected. Spreads were reported to have widened slightly for the first time in five years, a surprising result given the volumes traded through central order books. On the expense side, total operating costs grew for the third quarter running. Higher headcount was reported by +66% of respondents, suggesting that STP has not entirely prevented back office and compliance costs from rising with volumes. Nonetheless, traders reported a strong improvement in profitability.

Going forward, the sector is planning to commit less capital expenditure to IT projects – another unexpected result, given current investments being made by securities houses. One explanation may be that decisions are being delayed until the impact of the Financial Services Action Plan is clearer. Of those that do plan to invest, 81% cite the desire for efficiency improvements as their main motivation. Traders remain preoccupied with levels of demand, and appear no closer to clarifying their strategic vision for the future. Worries about the impact of regulation have also reached their highest level in five years. These concerns show how the sector remains essentially reactive to external events – whether shifts in demand, new regulation, or other factors such as terrorism.

**Figure 2: “Levels of demand and competition remain the factors thought most likely to limit business development, but worries over legislation and regulation have also reached their highest ever level.”**



\* Change from 'Domestic Competition' to 'Competition' reflects altered survey format in Q1 2004

**Fund management** respondents remain positive in mood, with a balance statistic of +47% feeling optimistic. Business volumes were reported to have risen by a balance statistic of +97%, the highest level recorded by the survey, and the sector took advantage of strong market conditions to increase its commission revenue. Nonetheless, confidence levels have fallen notably from the previous quarter's level, and the strong performance is not expected to be maintained. Growth in volumes and commissions is forecasted to slow across all customer segments in the coming period, despite the end of the tax year. Overall, fund managers seem to doubt whether the current recovery can be sustained.

The sector's levels of total costs were reported to have risen, with a steep increase in headcount (cited by a balance statistic of +95%) and strong levels of marketing spend the driving factors. Staffing levels are also expected to grow further in response to several factors, including the need to fill posts eliminated during the bear market, and regulatory focus on split capital trusts, market timing and late trading. However, new hires are also being used to improve performance and develop new products in areas such as structured products. Fund managers appear to have loosened their spending restraint, but in a measured way. A balance statistic of +66% intends to invest more in IT, the highest level of any sector, but this is strongly focused on improving operational effectiveness. The sector needs to be able to process higher volumes without having to add too many staff. Looking forward, lack of demand remains the key limitation on business development. Concerns over legislation and regulation have also climbed slightly, and the availability of professional staff is a growing worry – another indication that the sector is feeling pressure to produce innovative and higher-performing products.

## e-business section

The steady growth in financial services e-business continues. Nonetheless, the pace of adoption remains unexciting; only 5% of respondents expect that more than a third of their customers will be using the Internet within the next year. This represents a slow advance, given government statistics that half of UK homes now have Internet access, with 5% of the population using broadband.

In terms of barriers to e-business development, the majority of serious hurdles are perceived as being on the demand side. Customers' unfamiliarity with the Internet and the preference for traditional channels remain the greatest concerns. Worries over security have also grown, in response to threats such as 'phishing'. 'Phishing', which is discussed in the current DTI Information Security Breaches Survey, involves tricking a customer into entering their password onto a fake website. An unexpected result is that concerns over the speed of the Internet have gone up notably too. Overall, the survey results point to a customer base polarised into two groups: those who use the Internet, and are adopting it increasingly; and those who remain disinterested in web-based services.

In terms of e-business development, low-risk strategies are still preferred. After a slight up-tick in 2003, the appetite for launching new businesses has fallen back almost to zero. Consequently, it is established financial services companies that are expected to provide the strongest competition going forward.

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Elaine Hobson  
PricewaterhouseCoopers  
Southwark Towers  
32 London Bridge Street  
London SE1 9SY

or send an email to:  
elaine.hobson@uk.pwc.com

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### About this survey

The survey was carried out between 25<sup>th</sup> February and 10<sup>th</sup> March 2004. A total of 96 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 [pubsales@cbi.org.uk](mailto:pubsales@cbi.org.uk). The price for a single quarter for members is £46 and for non-members £83; an annual subscription for members £180 and for non-members is £325.

For further information about this bulletin, please contact Elaine Hobson, PricewaterhouseCoopers on 020 7213 4129.

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

Simon Jeffreys

### Insurance

Clare Thompson

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