

## CBI/PricewaterhouseCoopers Survey

June 2003

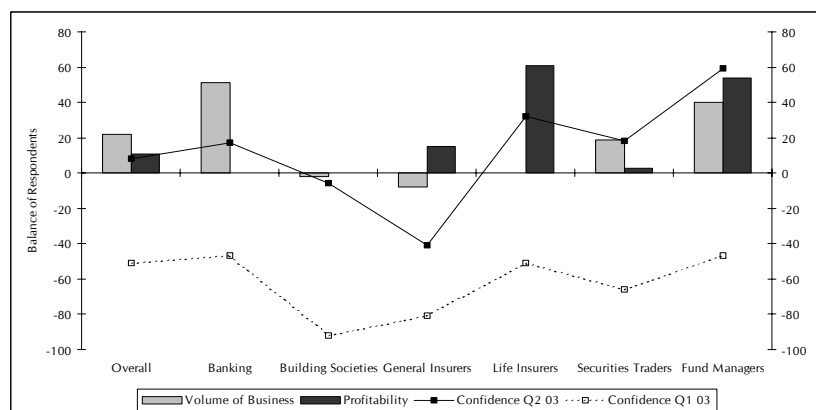
**“Three months of rising equity prices helped the industry to form a more confident view of its situation, after the depressed position of the previous quarter.”**

The 55th CBI/PricewaterhouseCoopers financial services survey saw an overall return to positive sentiment for the first time in a year. Three months of rising equity prices helped the industry to form a more confident view of its situation, after the depressed position of the previous quarter. Every major sector reported increased levels of confidence, and most returned to a positive outlook. The improvement was most notable in those sectors more leveraged to the equity markets, although the absence of any dramatic slowdown in the mortgage market was also a positive factor. However, while business volumes increased, the value of income was not much altered, suggesting that pricing competition remains strong across the industry.

Cost cutting has now become a common feature, with most major sectors achieving notable expense reductions. Headcount was widely reported to have fallen, and this is expected to continue. The industry is continuing to reduce its cost infrastructure, despite the pick-up in business recorded in several areas. The overall result of these cost reductions was sufficient to generate a slightly stronger level of profitability, despite the sluggish trends of income.

Despite the improvement in confidence, few sectors plan to increase capital expenditure in the coming year; those that do cited the need for improved efficiency as the rationale for investment. Looking to the medium-term, most sectors are predominantly concerned with levels of demand; many have become increasingly worried about the effects of statutory legislation. Despite some improvements, the industry remains uncertain about its outlook.

**Figure 1: “Every major sector reported increased levels of confidence... The improvement was most notable in those sectors leveraged to the equity markets.”**



A balance statistic of +17% in the **banking** sector felt more optimistic, reversing the trend of the last two quarters. Business volumes varied across different customer segments; although overall levels were reported to have increased, this is still driven by the personal sector, where growth remains positive. In contrast, business with industrial and commercial companies continued to fall, not an unexpected result but one that confirms the weakness in this sector of the economy. Lending spreads and interest income remain under pressure, but the banks have successfully responded in other areas: the value of fee commission and premium income was reported to have increased by a balance statistic of +38%, suggesting that the retail pricing war may be cooling.

Cost control remains a focus for the banks. Expenses were reduced during the quarter, owing to the fourth consecutive period of staff reductions. Offsetting the downward trend in costs, the value of non-performing loans was reported to have risen by a balance statistic of +43%, the highest level since 1993. This increase reflects deteriorating asset quality in the commercial sector, as borne out by recent Bank of England statistics. As a result, profitability was reported to have remained flat. Looking to the coming year, there are signs that the recovery in banks' confidence may have its limitations. A balance statistic of -29% expect capital expenditure on IT to fall in the next 12 months; this is the weakest level for over a decade, and is particularly notable given the potential impact of IAS introduction and preparation for Basel II. This caution is due to medium-term uncertainties over demand and the business environment. Concerns over statutory legislation have also increased notably, as banks consider the approach of mortgage regulation.

A balance statistic of -6% of **building societies** felt less optimistic about their business situation during the quarter. Despite being a negative result, this represents a significant improvement on the prior quarter, which saw confidence at its lowest level for over a decade. This improvement in sentiment contradicted the weak income trends reported, and may be attributable to relief that a housing market collapse has yet to materialise. Business volumes with private individuals were flat, a stronger result than had been predicted. This was due to the role of re-mortgaging and equity withdrawal loans, which supported volumes despite the slowing housing market. Unlike the banks, the societies could not increase fees and commissions, suggesting that the mortgage pricing war is unabated. Non-performing loans remain very low, and these manageable default levels helped the sector to maintain a flat level of profitability during the period.

The building societies continue to increase their cost base. In particular, they report an increasing headcount – the only sector to do so. This growth is explained by the continuing inability of the sector's infrastructure to deal with the high volumes of recent periods, and points to potential problems should a slowdown in business occur. Building societies remain disinclined to increase capital expenditure. Assessing the outlook for their business, respondents remain concerned about domestic competition and levels of demand. The prospect of mortgage regulation has also had an impact; statutory legislation is cited as a limiting factor by 75%, the highest level recorded by the survey.

A balance statistic of -41% of **general insurers** felt less confident during the period, making them the most pessimistic sector. Nonetheless, this was a significant quarterly improvement and implied, as suggested in March, that insurers may have been overly pessimistic at the start of 2003. Overall volumes of business fell, but the decline was most pronounced among private individuals; a trend forecast to persist as the sector anticipates

weakening in personal lines rates. A similar picture is suggested by results from insurance brokers, although this may also reflect concerns that brokers will lose personal lines market share to bancassurers. Business with industrial and commercial companies, where rates have remained firm, increased slightly, helping insurers to achieve a modest rise in the value of premium income. The sector also benefited from firmer equity and bond markets, improving investment income during the quarter.

General insurers continue to focus on expense reduction. Headcount was reported to have fallen, and staff reductions are forecast to continue as insurers adapt to the shifting cycle. However, cost cutting was tempered by a reported growth in commissions. The value of insurance claims grew; this was consistent with the last quarter but in contrast to unexpected negative balance statistics during the latter part of 2002. It seems that developments in the legal framework for personal lines claims, including the demise of organisations such as Claims Direct in 2002, may have affected these responses. The combination of changes in revenues, costs and claims led a balance statistic of +15% to report an increase in profitability. Although less positive than at many points in the past two years, this was a far more optimistic view than in the prior quarter.

Looking to the coming year, general insurers are planning to reduce their capital expenditure and marketing budgets. The chief reason given for limiting investment was uncertainty about demand. In reviewing the factors expected to limit development in the coming year, respondents highlighted levels of demand, domestic competition and statutory legislation. While these represent genuine concerns, the reductions in their absolute levels imply that the sector is forming a more sanguine view of its outlook.

After the problems of recent quarters, **life insurers** have returned to a positive mood, with a balance statistic of +32% feeling optimistic. Industrial and commercial company business was reported to have increased, and is expected to grow with the shift to defined contribution pensions and an improvement in the market for bulk purchase annuities. However, consumer business was reported to have fallen, despite evidence elsewhere of some recovery in the private savings market. Overall, the value of new business grew, helped by increased pension activity and high margin annuity business. An expectation of improving volumes in the coming quarter underlines the early signs of a recovery in the sector's confidence.

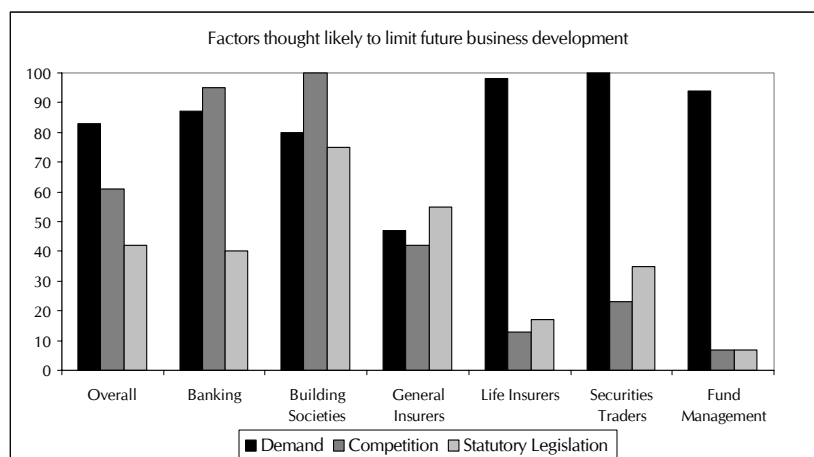
Life insurers showed a renewed focus on cost cutting, with operating costs reported to have fallen by a balance statistic of -80%. Headcount also fell during the quarter, and a balance statistic of -83% expect further staff cuts as the sector trims its cost base. Average commission costs climbed, but this did not prevent the positive effects of cost cutting from increasing the sector's reported profitability, with a balance statistic of +70% expecting profitability to improve, the highest level of any sector. In terms of capital expenditure, life insurers are the only major sector planning to invest more in IT in the coming year, and this after several quarters of increased spending. This reflects changing distribution strategies, market competition and downward pressure on costs. However, uncertainty over demand remains the key concern affecting the sector's future prospects, cited by 98%. Despite all the changes that have been made, and some hints of improving confidence, life companies do not seem to feel they are out of the woods yet.

Buoyed by three months of rising equity prices, a balance statistic of +18% of **securities traders** reported feeling more optimistic during the quarter. Volumes of business with private individuals increased, perhaps somewhat

surprisingly given the general disenchantment of retail investors, although recent stock market growth may have tempted some back to the markets. The commercial and financial segments also reported modestly increased business. Nonetheless, typical bear market indicators persist; overseas custom continues to decline and overall activity remains at a depressed level. There are also few signs that the pick-up in volumes has led to stronger revenues; the value of commission income was steady during the period, and is not expected to grow. Looking at costs, the sector reduced headcount for the eighth quarter running, as securities houses continue to pare their infrastructures. The result has been greater responsiveness to revenue growth, with an increase in profitability reported for the first time since 2000. Nonetheless, a balance statistic of -69% expect that staffing cuts will continue, suggesting that the sector still feels it has some slimming to do.

Turning to the future, securities traders appear uncertain about their prospects, despite the up-tick in confidence. Marketing and capital expenditure are expected to fall, owing to uncertainty over demand and business prospects. For those respondents that do plan to invest, greater efficiency is the motivation, with many houses still focused on straight-through processing. In terms of the general outlook, 100% of respondents see levels of demand as likely to limit growth, implying that questions about the strategic direction of the sector remain to be answered. Statutory legislation is now a worry for 35%, perhaps showing mounting concern over the potential impact of the EU Financial Services Action Plan.

**Figure 2: “The major sectors are predominantly concerned with levels of demand; many have become increasingly worried about the effects of statutory legislation.”**



The **fund management** sector saw a strong rebound in sentiment during the quarter. A balance statistic of +59% of respondents felt more confident, reacting to the pick-up in the financial markets. Investors are allowing themselves to hope that the equity markets may have turned, and that slow upward movement could continue. Volumes of business increased notably as the rally boosted the sector’s level of commissions. Financial institutions generated the most business, as fund managers benefited from pension fund activity and the increasing interest in alternative asset classes. In contrast to the experience of securities traders, business with private individuals failed to pick up.

Fund managers continue to make inroads on the costs front, with a balance statistic of -67% reporting a decrease in total operating costs and a decline

in staffing levels. Job cuts are expected to keep driving cost savings, as system quality improves and firms become less reliant on manual processing. Outsourcing also continues to gain ground, further aiding cost reductions. These reductions, combined with the steadying of the markets, helped a majority of respondents to report increased profitability.

Fund managers are expecting to spend less in the coming year on capital projects. Among those that are planning to invest, the desire to increase efficiency is the key motivation, cited by 100% of respondents compared with 53% in the past quarter. This reflects the wish to replace legacy systems with a more efficient infrastructure. As the sector improves its efficiency, it is becoming increasingly geared to market performance. This explains why, despite their increased confidence, fund managers remain deeply concerned about the impact of demand on their outlook.

## New Economy: e-business section

The value of financial services business transacted over the Internet continues to rise steadily, reflecting increased usage by existing online users rather than conversion of more customers to use of the Web. The reluctance of the majority of customers to use online channels is a major source of frustration to those who have invested in making such channels available: 60% of respondents cited this as the most crucial barrier to further e-business growth. Customer concerns over security remain a significant barrier, and it is unclear how or when they will diminish. In contrast, the speed of the Internet is becoming less of a problem, as broadband continues to penetrate UK households. Finally, while most organisations continue to focus on e-enabling existing activities, some now appear to be dusting off plans for e-business start-ups that have lain dormant since the dot.com crash.

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### About this survey

The survey was carried out between 26 May and 11 June 2003. A total of 107 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 is £83; an annual subscription for members is £180 and for non-members is £325.

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