

## CBI/PricewaterhouseCoopers Survey

December 2003

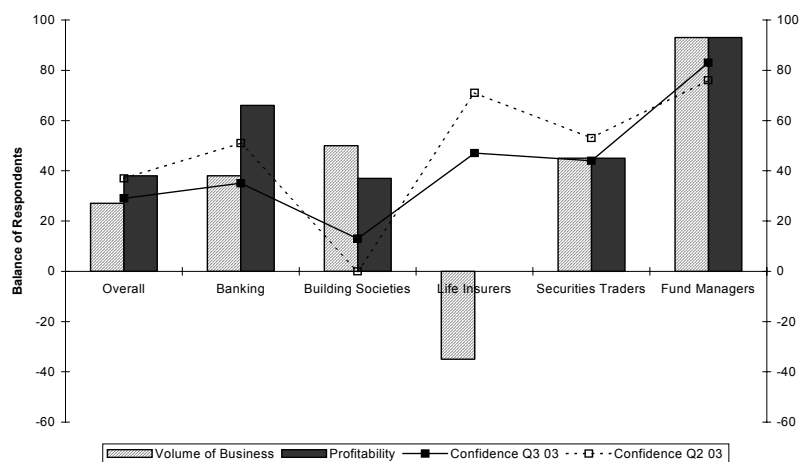
***“A continuation of the industry’s recovery, with respondents remaining predominantly confident... volumes grew across all customer categories.”***

The 57<sup>th</sup> CBI/PricewaterhouseCoopers financial services survey saw a continuation of the industry’s recovery, with respondents remaining predominantly confident. A more consistent view of the business situation appears to be forming; for example, building societies joined the other major sectors in reporting greater optimism. Volumes grew across all customer categories, delivering an overall increase in the value of income; a result supported by consumer-led economic growth and the continuing recovery in equities. Despite the expectation of further interest rate rises, there were no apparent signs of a consumer credit squeeze, or of excessive concern over house prices. Nevertheless, strong competition ensured that average spreads remained under pressure.

As predicted in the last survey, total costs rose – the first significant increase since 2001. However, business volumes grew faster, easing the average cost per transaction and helping to deliver a strong increase in profitability. Further cost increases are expected in the coming quarter as firms increase both training and marketing expenditure.

Looking forward, the impression of consolidating sentiment is reinforced by the strongest capital expenditure intentions for six quarters. It was notable that capacity expansion was cited as an increasingly important reason to invest. In reviewing factors likely to limit their development, respondents identified demand and competition levels as prime concerns. Statutory legislation is seen as another problem, with building societies, life insurers and securities traders increasingly worried.

**Figure 1: “A more consistent view of the business situation appears to be forming.”**



Note – General Insurance results not shown

A balance statistic of +35% of **banking** respondents felt more confident, reflecting continuing optimism. Volumes of business were reported to have grown, with the value of revenue also increasing despite ongoing pressure on spreads. Furthermore, the banks are optimistic that interest spreads will recover as further base rate increases take effect. The retail boom continues to be the main driver of growth, but business was positive across all customer categories, painting an upbeat economic picture. Mortgages remain important to the sector, but there was no indication of a slowdown in unsecured borrowing. Staffing levels remained static and are not expected to change materially in the coming quarter. This helped the banks deliver a strong up-tick in profitability, despite slightly higher levels of non-performing loans. An anticipated increase in training costs is probably related to mortgage regulation and preparation for IFRS.

Considering their future, banks show further signs of confidence, with a balance statistic of +55% planning more marketing – the highest level for three years. Greater capital spend is also foreseen, with the focus on improving the speed and efficiency of customer service. Domestic competition remains the biggest factor that banks believe will limit their growth. Worries over statutory legislation remained unchanged, indicating that the industry believes it can address recent public concern over lending practices without attracting significant new regulation.

**Building societies** reported an improvement in sentiment, completing their shift from a 'hard landing' view at the start of the year to a 'soft landing' consensus. A balance statistic of +13% felt more optimistic, the first positive result from this sector in a year and a half. The decline in volumes anticipated at the last quarter did not materialise; business was strongly positive, and fee income was also reported to have climbed. In contrast, average spreads are expected to come under further pressure, with the effects of competition offsetting the effect of higher base rates. However, interest income is expected to continue climbing as volumes grow. Private individuals remain the catalyst for expansion, with volumes in this segment at their highest level in almost two years. Non-performing loans remain a non-issue for the sector.

On the costs side, building societies continue to grow their headcount rapidly. Worryingly, this trend is expected to persist as the sector handles record volumes. The result was growth in total costs, although high volumes served to reduce costs per transaction during the period. Profitability increased, but the growth in expenses suggests that this will not be sustainable. The sector, showing increasing confidence, is responding to high volumes with more investment in branches and IT. Worries about demand have receded, suggesting greater confidence in the macro picture, but all respondents see competition as a limiting factor. The coming of mortgage regulation also led 77% to cite statutory legislation as a concern, the highest level recorded by the survey.

The **life insurance** sector remains firmly optimistic, with a balance statistic of +47% of life companies feeling more positive. It was therefore surprising to find a balance statistic of –35% reporting lower overall volumes and weaker business with private individuals. These findings look particularly odd given anecdotal evidence of strong business during the quarter, and may reflect weaker demand for with-profits products. Looking forward, responses offer another contrast – a balance statistic of +82% expect business to strengthen in the next three months. Volume expansion is also expected to exceed growth in the value of new business, suggesting greater reliance on low margin products. Respondents claim to have kept costs under control, and are hoping that they will remain at current levels. The sector appears to have defended its profitability, and is confident that future revenue increases will

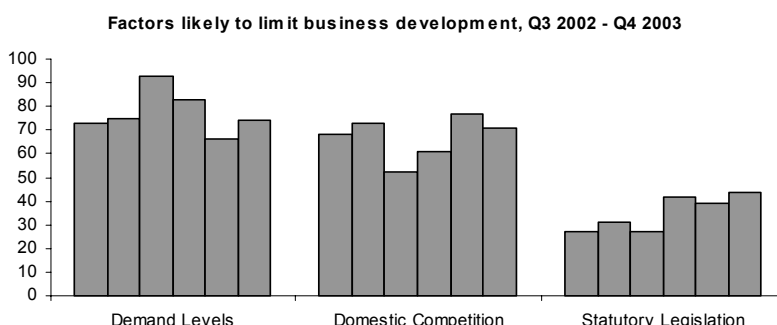
drop to the bottom line, despite planned marketing expenditure reaching its highest level in almost four years.

In reviewing their investment plans, life insurers look slightly less sure of a recovery. Capital expenditure intentions are modest, and concerns about lack of demand remain a factor, suggesting that the sector's confidence could yet prove fragile. Worries about the availability and cost of finance have receded as stock markets have climbed, but 85% cite statutory legislation as a limiting factor on their business. This reflects mounting concern over cumulative layers of regulation, and in particular the potential capital requirements set out in CP 195.

A balance statistic of +44% of **securities traders** reported feeling more optimistic, the third successive quarter of positive sentiment. Indeed, traders' responses this quarter clearly reflect increasing stock market values and trading volumes. Business grew across all customer segments for a second quarter, with private clients again leading the increase. This was a particularly welcome trend, given the suffering of this segment during the bear market. Traders were also successful at converting volume into value. Fee and commission revenue grew strongly and is expected to expand further, possibly helped by the start of a shift towards fee-based accounts. Growth in total costs was largely driven by rising headcount. This increase was partly due to higher activity levels, but may also reflect part-time staff working on compliance projects. Traders reported another quarter of improved profitability, but the growth in expenses suggests that this was largely volume-led.

Going forward, the sector appears ambivalent about the need for investment. Marketing spend is expected to grow by a balance statistic of +22%, the highest level since 2000; but capital expenditure plans are forecasted to fall, with IT spending dropping back from last quarter's peak. Statutory legislation is seen as the second most serious limitation on business, illustrating the growing burden of compliance and regulatory interest in 'soft commissions'. Level of demand remains the prime concern; this may not be surprising in such a market-led sector, but if securities houses are so uncertain about long-term direction, they may risk ceding market share to alternative, more direct business models.

**Figure 2: "Respondents identified demand and competition levels as prime concerns. Statutory legislation is seen as another problem, with building societies, life insurers and securities increasingly worried."**



After two quarters that saw their high expectations exceeded, **fund management** respondents are bullish. Optimism reached a balance statistic of +83%, the highest level in over a decade. Business volumes and the value of fee income were reported to have grown by a balance statistic of +93%. This surge of activity has been driven by the private individuals category, which generated strong sales during 2003. Commercial and overseas

customers also showed resilience, but financial institutions appear to be holding back at present. These results contrast strongly with the current woes of the US investment management industry. Fund managers are spending more in the search for expansion; and with the sector reporting greater profitability, cost levels are expected to continue rising as funds are freed up to invest in business generation. Headcount growth contributed to cost inflation, and may stem from 'doubling-up' at the start of outsourcing initiatives.

Fund managers' plans for the future demonstrate further signs of their confident mood. A balance statistic of +91% expect to spend more on marketing. Although coming from a low base, this is the highest level in nine years, and illustrates the view that revenues are becoming more correlated with marketing spending. The sector may also be spending more on brand building, in an attempt to pre-empt the possible effects of scandals in the industry. Investment plans for IT are modest, but expansion of capacity is stated as the prime reason to invest for the first time in several years. Fund managers appear phlegmatic about their prospects, despite some concerns over short-term demand. Worries about statutory legislation remain subdued; although the risk of fresh legislation may be remote, this is surprising given the level of regulatory interest in the sector. Respondents appear confident that problems in the US will not spread to the UK. The availability of professional staff is cited as a concern by 25%, the highest level since 2000 - another indication of growing confidence.

## e-business section

The key trends identified in financial services e-business in recent quarters continue to shape the industry. Levels of business conducted over the Internet are still increasing, albeit slowly; and the 'expectation gap' continues to narrow as growth forecasts become more closely aligned with reality. The availability of professional staff and the need for an innovative corporate culture are seen as slightly more significant barriers to development than in the past year; this may indicate that some businesses are starting to consider further innovation. However, most strategies for online development remain focused on adapting existing businesses; the only route to new ventures receiving serious consideration is the use of collaborative alliances, favoured by 25% of respondents.

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### About this survey

The survey was carried out between 21<sup>st</sup> November and 3<sup>rd</sup> December 2003. A total of 88 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.

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