Financial Services Survey

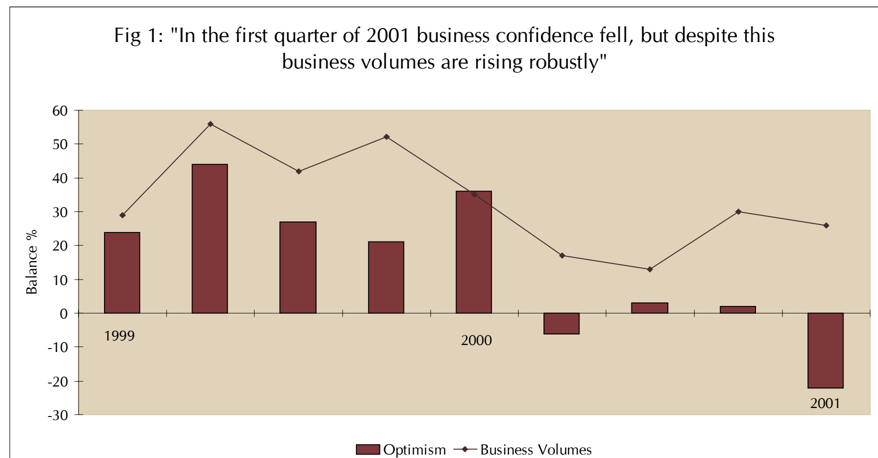
PRICEWATERHOUSECOOPERS

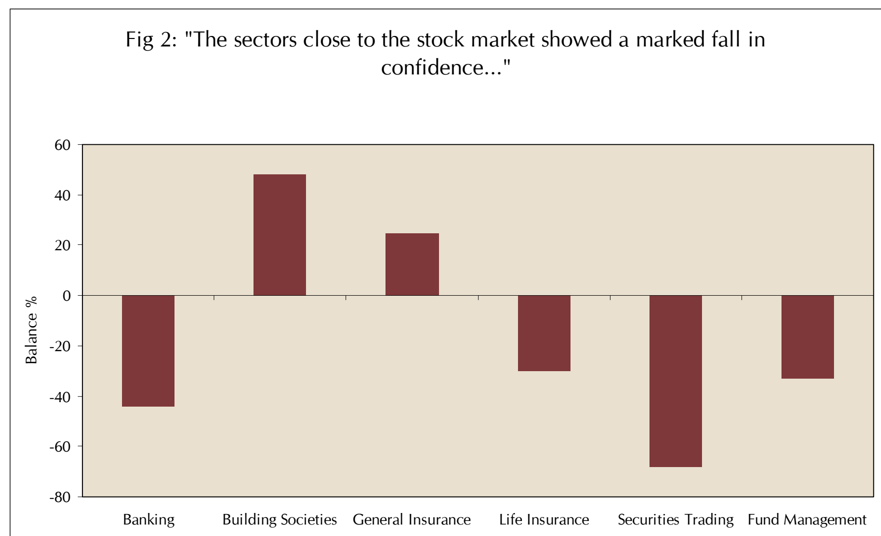
CBI/PricewaterhouseCoopers Survey

March 2001

"A fall in business optimism, but the economic fundamentals are still healthy"

In the first quarter of 2001 business confidence fell, but despite this business volumes are rising robustly. The industry reported only a slight improvement in profitability, and no significant change is expected in the coming months. Large parts of the survey may well have been overshadowed by the economic slowdown in the US and its impact on the stock market in the UK. But as revealed below not only are economic indicators positive in many of the sectors, key business indicators are also positive.





The 46th CBI / PricewaterhouseCoopers survey revealed a contrast between quite robust business indicators supported by healthy economic fundamentals and falling confidence, with survey respondents bracing themselves for a possible downturn in business. The sectors close to the stock market showed a marked fall in confidence, although in some cases, particularly banking, the real business indicators were still strong.

Banking reported a steep fall in business confidence despite a number of very strong indicators for the sector. Banks reported increases in the volume of business, value of fee income and overall profitability, all of which were comfortably above expectations in the last survey. Numbers employed fell for the third consecutive quarter and we can see the effect of this on total costs, which have also fallen since September last year.

Confidence appears to be overshadowed by fears over the economy although economic fundamentals in the UK remain good. The fall in optimism reflects concerns about the US slowdown, which is expected to have an impact on lending to businesses. A weak stock market has a negative effect on sales of equity products, but the industry's biggest concern will be the possibility of a fall in consumer confidence, which is a key driver for retail banking. The sector must be careful not to talk itself into a recession. Although volumes are forecast to continue increasing, too much speculation on the prospect of a recession could be self-fulfilling. If banks take too conservative a view on lending, this will tend to accelerate any fall in both business and consumer confidence.

In a marked contrast to the banking sector, **building societies** registered the biggest rise in business confidence since September 1996. Confidence in the banking sector may have been affected by its exposure to a wider range of equity products, but building societies' business is still skewed heavily towards mortgages. Optimism in the housing market is affected less by stock market jitters and more by the level of employment and low interest rates, both of which are in a healthy position. In February 2001 the Halifax reported a fall in average house prices of 0.8% and the Nationwide reported a rise of 1.6%, but both organisations agreed that the outlook was positive. This was helped by the Bank of England's decision to cut base rates by a quarter of one percent in February with the prospect of further rate reductions, which should sustain confidence in the housing market. This in turn drives optimism for building societies.

Business confidence remains strong for **general insurers** who continue to benefit from an upturn in what is a classically cyclical market. The sector has now recorded a positive balance statistic for business volumes and overall profitability for two years. Prior to that, overall profitability recorded fifteen consecutive quarters of negative growth, apart from a blip in September 1998. There have been a number of changes in the market structure since the last downturn in the cycle, including the increased market share of the major players, which might sustain the current upturn.

The survey did however reveal changes in two indicators, which are of concern to future profitability. The most important motive for capital expenditure is now capacity expansion, mentioned by four out of five respondents, the highest proportion ever recorded by the survey. Furthermore, the survey revealed that shortage of finance is not a factor likely to limit capital authorisations over the next twelve months. Total costs also rose significantly over the past three months and are expected to rise at a faster rate over the next quarter. Capacity increases in a mature market do not

augur well for sustained rate increases and together with increases in costs could threaten the very favourable business environment currently enjoyed by general insurers.

During the first quarter of 2001, business confidence fell for **life insurers** as a forecast increase in volumes failed to materialise. The current economic environment and fall in share prices has resulted in a reduction in demand for savings products. This was the first survey to be conducted after the Equitable Life closed its doors to new business, which could also have contributed to a more pessimistic environment.

The value of premium income fell moderately and this is expected to decline further. Weak demand factors will not be helped by the structure of the market, which has not experienced the same degree of consolidation as the general insurance market. There are more substitute products, particularly from the investment fund industry, and this, combined with a more fragmented industry structure, means stiffer competition. On a more optimistic note, the survey reported a reduction in total costs for the second successive quarter, which suggests that life insurers are responding to the competitive and regulatory challenge posed by stakeholder pensions. As a result profitability rose notably and is forecast to continue rising.

Not surprisingly business confidence fell over the past three months amongst **securities traders**. During the period the survey was conducted, the London stock market hit its lowest point since the Russian crisis in 1998. On 13 March 2001, the FTSE 100 closed at 5720.7, its lowest since December 1998. Whereas the banking sector's pessimism is contrary to several key indicators, pessimism in this sector is supported by a number of factors. Both business volumes and the value of fee/commission income fell despite expectations of growth last quarter. Although a fall in profitability was expected, the actual fall was more than forecast. The level of business with financial institutions is expected to fall marginally and it is possible that the full impact of the Myners Review was not captured by this survey.

Fund managers reported a fall in business confidence for the second consecutive survey. The volume of business fell and is expected to fall significantly over the next three months. In separate reports, the industry has suggested that sales of ISAs are down by between 15 and 40 per cent this year compared to last year's ISA season. Again this is related to stock market concerns and ISAs that are in demand tend to invest in bonds and cash rather than equities.

There is some evidence that the sector is starting to heed warnings on cost control. Total operating costs fell modestly over the past three months for the first time since September 1995. It is vital for the sector to bring costs under control and the Myners Review will provide a new impetus. In March 2001, the Fund Managers Association argued that UK-based fund managers could be left at a competitive disadvantage to overseas rivals by proposals to reform the way they charge pension funds for brokers' services. Myners calls for greater transparency relating to the costs of brokers research and share dealing, but this would mean different rules for UK fund managers. It could also end the practice of soft commissions where brokers pay for fund managers' costs in return for winning share-dealing contracts. At this stage it is not clear whether fund managers or securities traders will absorb the costs.

New Economy Section

When we launched the new economy section at the end of last year, the first survey revealed that there had been a reality check and the industry was taking a more considered approach to e-business development. The results from March's survey confirmed those findings. It points to growth in the overall value of Internet business across the industry, but at the same time, the speed of diffusion of Internet business is not as fast as expected.

For most sectors of financial services, and particularly the banks, the Internet presents a dilemma. Organisations are trying to switch their customers to the Internet to cut costs, but the switch must be managed so that they can still cover the higher costs of established distribution channels. Channel strategy is an ongoing challenge for players who do not want to damage revenues. At the same time competition will come from aggressive competitors, usually with a distinctive brand, who combine an Internet channel with an aggressive pricing stance.

Competitors who adopt this strategy are naturally attracting "price promiscuous" customers and the particular challenge for those organisations is keeping a substantial proportion of the customers they acquire. To this end, the market has seen a proliferation of loyalty programmes. Cahoot, for example, offers a better deal according to the number of products and services you have. Established banks with a strong branch network offer a multi-channel strategy to hold on to customers, the majority of whom are reluctant to give up branch banking and are happy to take advantage of a choice of channels. Established banks also argue that they have already lost these promiscuous customers, first to building societies, then to supermarket banks, Standard Life and now Cahoot and IF.com. There is a paradox in that everybody is fighting for the least profitable and loyal customers.

Seventy-six per cent of respondents cited web-enabling of their current business as the strategy adopted to develop e-business activities, up from 62% in December. The change in the mix of answers suggests a move away from risky options to more conservative strategies. Collaborative alliances increased for banks and securities traders and this mirrored a number of corporate announcements recently. Capital markets have been threatened by disintermediation and the high fixed cost nature of their business demands that securities traders search for revenue from a new group of customers.

The main barrier to e-business development remains a lack of understanding, which is consistent with December's survey. The speed at which the Internet works rose as a barrier to e-business development, and speed at which web services are available on new platforms emerged as an issue. This suggests that operators are frustrated with web access through personal computers and slow telephone lines and see new platforms as a possible solution. Internet banking through television could be the next step for e-business development in the sector.

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Angela Patel
PricewaterhouseCoopers
Southwark Towers
32 London Bridge Street
London SE1 9SY or send an email to:

angela.patel@uk.pwcglobal.com

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About this survey

The survey was carried out between 22 February and 14 March 2001. A total of 147 companies responded including banks, building societies, finance houses, securities traders, fund managers, commodity brokers, private equity, 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. 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.

For further information about this bulletin, please contact Angela Patel, PricewaterhouseCoopers, tel: 020 7804 7083.

To discuss the implications for the various sectors, please speak with 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

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Simon Jeffreys

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