

March 2003

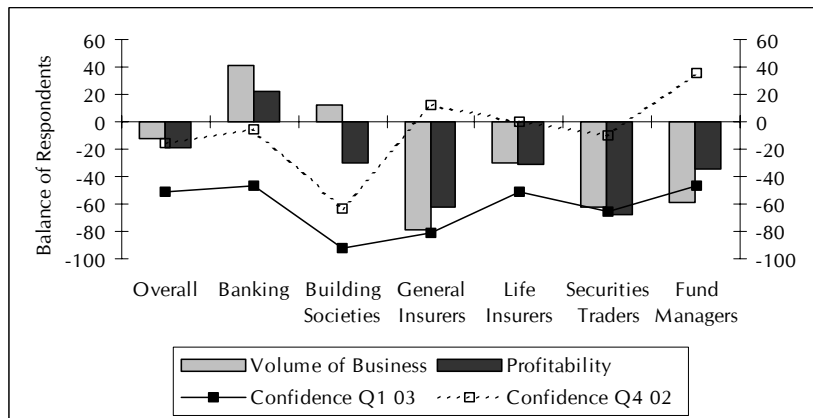
“Overall business optimism reached its lowest level for five years, influenced by uncertainty in the Middle East and slowing economic growth”

The 54th CBI / PricewaterhouseCoopers financial services survey indicated that overall business optimism reached its lowest level for five years, influenced by uncertainty in the Middle East and slowing economic growth. In contrast to recent periods, there was a decline in optimism across all the major sectors. Dramatic deteriorations in sentiment from the prior quarter among general insurers and fund managers were particularly notable, although the reasons for pessimism varied from sector to sector. With the exception of personal lending, volumes of business fell in most product areas. Weakness of demand impacted pricing, leading to a decrease in the value of income.

Headcount fell across the industry, as had been anticipated, and this trend is expected to continue. However, overall costs remained level as some sectors found efficiency gains harder to achieve than expected. This led to a reported overall fall in profitability, although some sectors, notably banking, remain strongly profitable.

Influenced by the operating environment, investment intentions have declined; any potential expenditure will be justified mainly on the grounds of improving efficiency. Not surprisingly, euro-related investment remains at a minimal level. Looking ahead, demand levels have become by far the dominant concern of respondents, cited by 93%. This is the highest level in over a decade, and reflects uncertainty over the economic outlook, as well as the geopolitical situation.

Figure 1: “In contrast to recent periods, there was a decline in optimism across all the major sectors.”



Optimism in the **banking** sector fell to its lowest level in over four years. It reached a balance statistic of -47%, despite producing the most positive business level responses of any major sector. Banks increased their volumes of business, underpinned by the personal segment as the consumer boom continues. In contrast, business with industrial and commercial customers

declined; this segment appears to be faltering once more, as companies defer investment in the current climate. Overall however, banks reported increased revenues. Despite pressure on average spreads, fees and commissions held up well, driven by personal lending products such as fee-based credit cards. Levels of non-performing loans grew slightly, with the growth almost entirely concentrated in the corporate area. Personal sector arrears remain at historically low levels, reflecting the low interest rate environment.

Banks reduced their headcount during the quarter, although personnel reductions were harder to achieve than anticipated. However, staffing costs as a percentage of total expenses rose, possibly reflecting the overtime requirements of processing high personal lending volumes. Nonetheless, costs per transaction were reported to have declined, with the result that banking was the only major sector to report increased profitability during the period. Banks intend to increase their investment in land and buildings in the coming year, with the search for greater efficiency given as the key motivation to invest. The availability of clerical staff was also seen as a limitation by 39% of respondents, the highest level recorded. These results suggest that further investment in call centres and more centralised back-office processing is planned. More generally, 99% of banking respondents see level of demand as the factor most likely to limit future expansion.

A balance statistic of -92% of **building societies** felt less optimistic about their business situation during the quarter. This was the lowest level since 1991, and is based on worries that demand for mortgages will fall. Business volumes held up well during the quarter, with equity withdrawal loans thought to be a major contributor. Looking forward, building societies are distinctly negative about the prospects for business, with a balance statistic of -83% expecting to see volumes reduce in the coming quarter. Building societies are also concerned that they will find themselves competing even more with the banks as the mortgage market cools. The sector's negative views are emphasised by the dramatic fall in expectations for personal business for the coming period.

On the cost side, building societies continue to struggle with infrastructure issues. After taking on staff to cope with the boom, they continued to hire during the quarter, despite decreases in fee, commission and margin income. This suggests that the sector could have serious profitability problems if volumes decrease as forecasted. Increased headcount was the key driver of a strong upturn in costs, and this resulted in a balance statistic of -30% reporting a fall in profitability. The only positive news was that non-performing loans remained at low levels. Although marketing spending is expected to rise, capital expenditure plans are lower than in the prior quarter, with uncertainty over demand a concern for 87%. Almost all respondents (99%) see domestic competition as the factor most likely to limit business in the coming year.

In the **general insurance** sector, confidence fell dramatically, with a balance statistic of -81% feeling less optimistic - the lowest level recorded by the survey since its launch in 1989. While the sector may have appeared unduly optimistic in recent quarters, it is surprising that it has now become so pessimistic. Volumes of business and the value of premium and investment income were reported to have fallen, with the outlook in these areas strongly negative. These results reflect concerns over the UK economic outlook, and a belief that the general insurance cycle has turned. General insurers are not only expecting lower business volumes, but a softening of rates as underwriting slows. A key area of concern was the strong deterioration in business with private individuals, reported by a

balance statistic of –82%. This trend is expected to continue in the coming quarter, reflecting fears that economic factors will affect the behaviour of individual customers.

There was mixed news for the sector on the expenses front. Having made cost cutting progress during the previous quarter, general insurers achieved further reductions during the period. Headcount was widely reported to have fallen as costs were taken out. However, reduced volumes led to an increase in costs per transaction, and the value of claims grew slightly after three quarters of decline. Overall, a fall in profitability was reported by –62%, the largest balance statistic since 1997. Looking forward, marketing and capital expenditure are expected to fall, with improving efficiency the focus for any investment. Competition is seen as less of a limitation on growth, but concerns of a cyclical slowdown mean that business levels are the key area of uncertainty for the sector. Uncertainty about statutory legislation remains high, as the sector anticipates the FSA's involvement in prudential regulation, and the prospect of new EU regulation of insurance distribution.

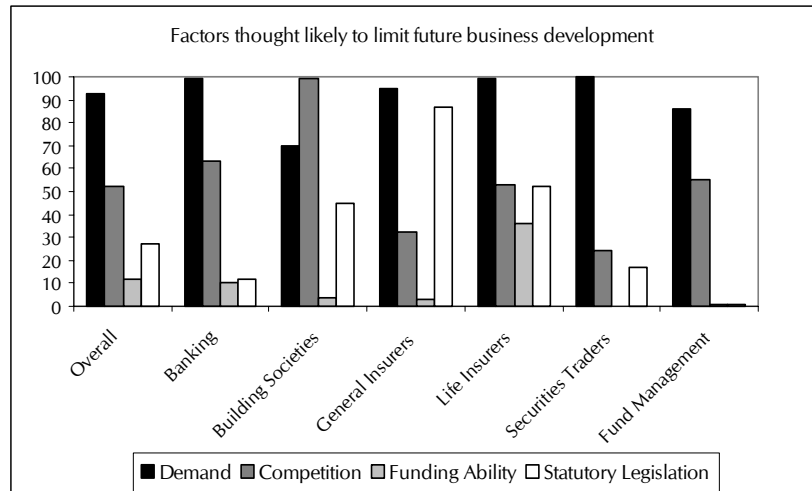
The **life insurance** sector returned to a more pessimistic outlook during the quarter. A balance statistic of –51% felt less confident, not a surprising result given the expectations of economic deceleration, and consumer disinclination to invest in an environment of falling equity markets. Hopes for stable revenues during the quarter did not materialise, with volumes of business and value of income reported to have fallen. Business with institutional customers declined, reflecting a lack of investment by the corporate sector. There was a small increase in business with private individuals, which is expected to continue into the coming quarter. Life companies may be hoping that the government will encourage greater pension provision; but this optimism is in strong contrast to the views of the general insurance, fund management and insurance brokerage sectors.

Life insurers continue to trim costs, with headcount reduced by a balance statistic of –74%, a trend expected to continue. The cuts in staffing may be influenced by planned overseas relocation of back office processing - although this is unlikely to have had a large impact in the quarter - and the falling need to process redress claims. A focus on outsourcing may also explain an increase in IT investment plans. Greater efficiency is seen as the chief reason for capital expenditure, although the desire to replace assets and reach new customers was also cited. Factors limiting capital expenditure include the cost and availability of finance, reflecting the sector's depleted capital base. Looking forward, 99% of respondents see level of demand as inhibiting future growth, with the threat of statutory legislation remaining a concern for many.

A balance statistic of –66% of **securities traders** feel less optimistic about their business situation, with business levels remaining below normal. The value of commission and trading income fell, and further declines are expected in the coming quarter. Volumes were also reported to have fallen across all categories of customer; somewhat surprising, given that volatility and transactional volumes in the financial markets continue to trend upwards. Indeed, recent first quarter results from some major houses showed strong fixed income and currency trading results. The survey responses may reflect securities traders still coming to terms with the realities of the bear market in equities. The sector continues to cut its cost base, with staff numbers falling and further headcount reductions expected in the coming quarter. Even so, weak revenues led to a fall in profitability being reported by a balance statistic of –68% of respondents.

Given market conditions, securities traders remain gloomy about prospects for the coming year. Marketing expenditure is expected to fall, and less capital expenditure is planned across all areas, with uncertainty over demand the predominant reason for deferring investment. Levels of demand are also seen as likely to limit business growth by 100% of respondents.

Figure 2: “Looking ahead, demand levels have become by far the dominant concern of respondents, cited by 93%.”



The **fund management** sector reported a fall in sentiment during the quarter, with a balance statistic of –47% feeling less confident. A third consecutive period of slowing business and shrinking income has left the sector in a gloomy mood. Most notably, business with private individuals was reported to have fallen by a balance statistic of –86%. This is significant, given the sector’s reliance on the end of the tax year to generate fund inflows, and was the key factor behind the fall in confidence. However, fund managers have responded to weak demand in the personal sector by developing cash funds for corporate clients, and by trying to market their products in Europe. These efforts were reflected in increased business with institutional and overseas customers. Nonetheless, the popularity of funds supermarkets, and the increasing distribution fees being levied on fund managers, led to a fall in the value of net commission income.

Cost cutting remains a focus for fund managers. A balance statistic of –59% reported a reduction in headcount, and total costs fell; but despite these efforts, profitability declined for the third quarter running. Fund managers are anticipating a fall in marketing spend, reflecting their poor expectations for the ISA season. Capital expenditure is also expected to reduce, owing to uncertainty of demand. The desire to invest for greater efficiency has fallen, as fund managers see cost reduction as the only route to improved profitability. As in other sectors, level of demand is seen as the factor most likely to limit business levels in the coming year.

New Economy: e-business section

The survey results show that the value of financial services business transacted over the Internet has risen. Almost half of respondents (48%) now report conducting more than 10% of their customer business online, and this growth is expected to continue, although at a slower rate than had been predicted in prior periods.

Barriers to e-business development are reported to have fallen in most areas. There is a perception among industry participants that barriers are starting to come down as expectations of Internet usage increase. One area, however, where barriers are perceived to have risen is data privacy, an issue that has grown slightly in significance, reflecting the publicity surrounding the appointment of a new information commissioner. Overall, converting customers from infrequent, cautious Internet users into habitual, confident ones remains a key challenge for financial services companies.

There was a general withdrawal from launching new e-business initiatives during the period. The area where this was most marked was collaborative alliances, an expansion strategy used by 33% of respondents in the last quarter, but only 18% in the current period. This reluctance to spend is matched by the overall investment profile of the sector; financial services companies are using e-business to focus on improving their efficiency, rather than targeting new customers or markets.

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About this survey

The survey was carried out between 24 February and 12 March 2003. A total of 118 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.

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