Financial Services Survey

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CBI/PricewaterhouseCoopers Survey

June 2001

"Confidence stabilises, but volume and profitably indicators show why the industry is switching its focus to cost control"

Following a fall in optimism earlier in the year, business confidence stabilised despite the fact that business volumes did not rise in line with expectations. It was more surprising when you consider that overall profitability declined moderately for the first time since June 1995. Life insurers reported a decline in business confidence, while building societies, securities traders and fund managers reported rises. Banks and general insurers reported little change in their confidence about the business situation.

The 47th CBI / PricewaterhouseCoopers survey revealed that many of the sectors were focusing on reducing costs, but with varying degrees of success. Investment intentions in information technology are still positive, but are the least positive since December 1996.

In the **banking** sector business confidence stabilised after the sharp reduction in the March survey. This was despite a fall in the volume of business and pressure on margins. The volume of business fell and average spreads narrowed at the fastest rate for eighteen months. It was surprising to see costs rising while volumes were lower, which suggests the sector is having difficulty holding down costs.

The value of non-performing loans emerged as an issue in this survey, 42% of banks said that the trend was up over the past three months. Apart from a blip in 1998, this was the first increase since 1993. Further analysis of the results showing the trend in volumes suggests it is the corporate sector that is struggling rather than the personal sector. The trend in the volume of business with regard to private individuals is expected to rise strongly over the next three months maintaining a pattern of recent surveys. However, the trend in volumes with regard to industrial and commercial companies is expected to fall.

On the face of it, the expected increase in numbers employed is inconsistent with the rest of the survey, which shows that banks expect costs to come down. The implication is that banks are recruiting more lowly paid clerical staff, for example to man call centres, whilst still shedding more highly paid jobs. This finding is supported by the statistic showing an expected increase in training expenditure.

Sixty six per cent of banks expect statutory legislation to limit their ability to increase the level of business over the next 12 months and this may reflect concerns about statutory legislation and how the government will tackle regulation of the small business sector.

The **building society** sector is the most optimistic sector covered by this bulletin, albeit lower than last time. Confidence was no doubt buoyed by a growth in volumes, which was much greater than anticipated in the last survey. Growth in volumes would have been fuelled by lower

interest rates and the impact of the Bank of England's decision to cut the rates in February will have been felt in this quarter. As you would expect, average spreads continued to narrow. In contrast to banks, the value of non-performing loans continued to fall significantly showing that the fall in volumes and confidence is largely limited to the business sector; consumer confidence remains strong.

During the quarter a number of pieces of research were published debating the rise and possible fall in house prices. On the one hand, Cambridge Econometrics, which examined the relationship of house prices to household income, warned that house prices in the UK's most densely populated regions are not sustainable. In the south-east it reported that the current average ratio is 4 times compared with a historic average of 3.7, a level not seen since the overheated market of 1988 and 1989. On the other hand, Gerrards, the stockbrokers, argued that homebuyers were currently spending 17% of their income on their mortgage, compared with a long-term average of 22% and a peak of 40%. The industry itself seems to favour the Gerrards view.

Key indicators in the last quarter's survey for **general insurers** raised the spectre of a peak in the insurance cycle. Volume growth, which rose sharply over the last quarter remained high as did profitability, but noticeably forecasts for volume and rate growth suggest a slowdown, particularly in the personal lines sector. Average operating costs fell over the last quarter and are expected to fall in line with more moderate volume growth. It is also encouraging that the trend in total operating costs, while still positive, fell to a more sensible level.

A balance of 22% of general insurers expect to authorise more capital expenditure on IT in the next twelve months than in the last 12 months, which is much lower than in previous quarters suggesting that general insurers are cutting IT investment at the top of the cycle. Statutory legislation as a factor likely to limit their ability to increase the level of business also emerged as a concern in this sector reflecting worries about a new regulatory regime.

In the **life insurance** sector business sentiment was still fragile. It was the only sector in financial services with a significantly negative sentiment, and profitability fell slightly compared to expectations of an improvement. This was however less pronounced than last quarter when confidence was probably affected by the problems at Equitable Life. The overall volume of business was up over the last quarter and is expected to continue rising over the next three months. An expected rise in the value of new business did not materialise, but the sector is still hopeful of an increase over the next quarter.

Total operating costs rose despite expectations of a fall, which suggests that life insurers are struggling to lower costs. Although the sector may be able to write new business at a lower cost, to really attack its cost base, the sector has to make fundamental changes to the complicated network of legacy systems which in many groups are a function of consolidation. So far the sheer complexity of the problem has prevented insurers from making sufficient strides. It is anticipated that this issue will become more pressing. Adequacy of systems capacity as a factor likely to limit the sector's ability to increase business levels rose in importance. It is also interesting that, unlike general insurers, the sector does not expect to cut back on capital expenditure authorisations for IT over the next year. The trend in numbers employed rose and it is likely that the sector recruited staff to sort out regulatory issues throughout the quarter.

Business confidence amongst **securities traders** has improved and a balance statistic of 13% of respondents are more optimistic about the overall business situation in their sector. Optimism in this sector is heavily influenced by the stock market and it is clear that the rebound in confidence is a reflection of a more stable market. Business volumes are still falling and although the sector, which is forecasting a rise in volumes, believes it is over the worst, the reality might be different.

For the second consecutive quarter, the trend in numbers employed is flat despite forecasted cuts, a clear sign that the sector is wrestling with its headcount. This point is underlined when we consider the trend in staff costs as a proportion of total costs, which continues to record a positive balance statistic. For the first time in a year the sector expects to authorise less capital expenditure on IT. The first thing that securities traders cut when business suffers is expenditure on systems.

In the **fund management** sector, business optimism rose by forty-four percentage points, but looking at the statistics it is hard to see where this burst of confidence is coming from. The volume of business fell substantially and overall profitability decreased at the fastest rate for eleven years.

Confidence could stem from some success in cost cutting, total operating costs fell for the second consecutive quarter. Galvanised into action by the possibility that the *"ten year bubble"* might burst, fund managers are cutting back on their marketing, taking a knife to back office expense and moderating expectations on bonuses. In the area of IT cost cutting activity is also evident and the sector expects to authorise less capital expenditure on information technology over the next 12 months. This will be a difficult balancing act for fund managers who want to take out costs, but not at the expense of further investment required for straight through processing under T+1. The fundamentals have changed in this sector and external requirements are becoming more onerous.

New Economy Section

Internet business increased, but the rate of growth is much slower than expected, an indication already witnessed in previous surveys. A balance of 41% of financial services firms reported that the total value of their Internet business with both customers and suppliers has increased over the past quarter. Of the respondents that reported an increase, a balance of 33% said the rise had been slower than expected, consistent across the financial services industry. The level of business may be going up, but it is clearly not meeting initial expectations, jeopardising some over optimistic business cases.

Over 80% of respondents cited the web enabling of current business activities as a strategy adopted to develop e-business activities. Increasingly, the Internet is becoming very much a *"cost play"* in financial services, with the focus on taking costs out of the business. The main *"income play"* is the extension of current business activities. Previously popular strategies such as launching a greenfield site or a new brand are virtually extinct in today's climate.

The most cited barrier to e-business development continues to be a lack of understanding on the part of customers and/or suppliers, though respondents believe this barrier will decrease over the next 12 months. The lack of security standards remains a critical barrier, particularly for banks, building societies and fund managers; respondents in these

sectors believe security issues are getting worse and will be the biggest barrier to e-business development in 12 months time. Security is less of a concern to general and life insurers, where, because of the nature of the transactions, fears about security tend to deter consumers less.

For the first time since this survey began, the majority of respondents in all sectors reported that competition was not coming from corporates outside financial services. Competition from within the sector remains a key concern. An interesting development is the shift towards the provision of advisory services online, the most striking example of which is the "advice model" pioneered on the Charcolonline web site. This is part of a multi-channel strategy aimed at building customer relationships through the quality and accessibility of advice offered.

Multi-channel strategies, where financial services organisations use the Internet to supplement their existing branch or direct networks are likely to predominate until the cost and performance dynamics shift significantly, rendering other channels unprofitable. Broadband access potentially provides such a shift, through, for example video links that provide face to face advice online. We may therefore see the return of the Internet start-up at that stage. In the meantime, it will be the existing financial services organisations developing e-business services as part of a multi-channel strategy.

Fig 1 "It was more suprising when you consider that overall profitability declined moderately for the first time since June 1995"

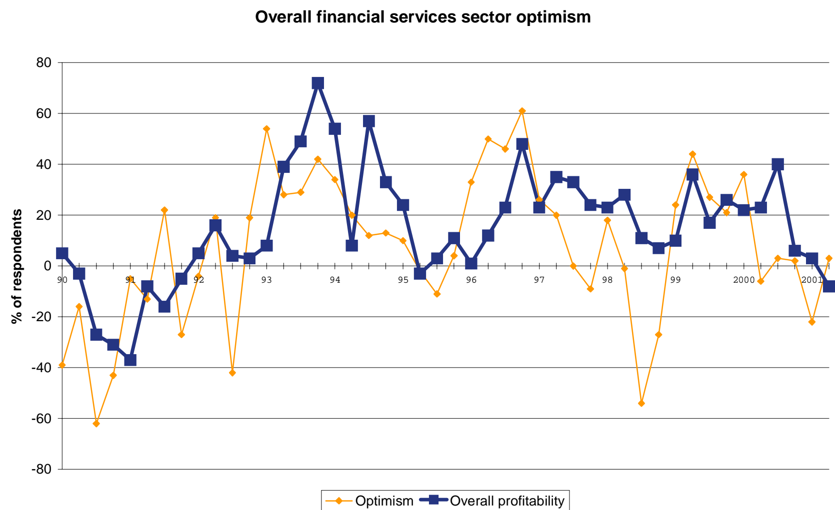
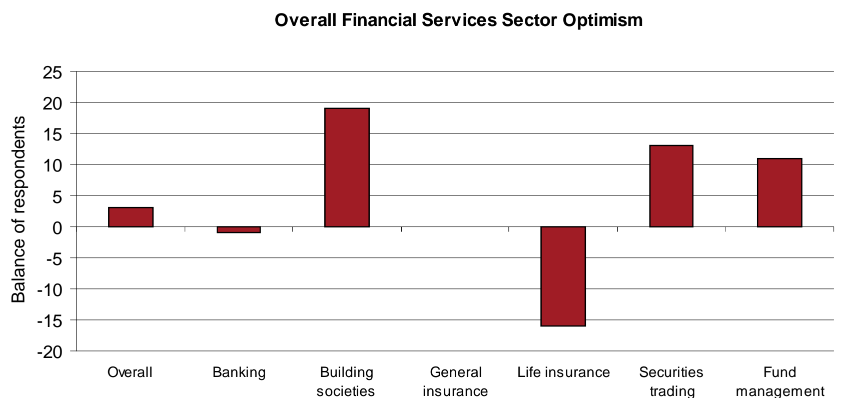


Fig 2 "Life insurers reported a decline in confidence, while building societies, securities traders and fund managers reported rises"



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About this survey

The survey was carried out between 24 May and 13 June 2001. A total of 135 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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