Financial Services Survey

CBI/PricewaterhouseCoopers quarterly survey

Sharing insights and trends from the financial services industry*

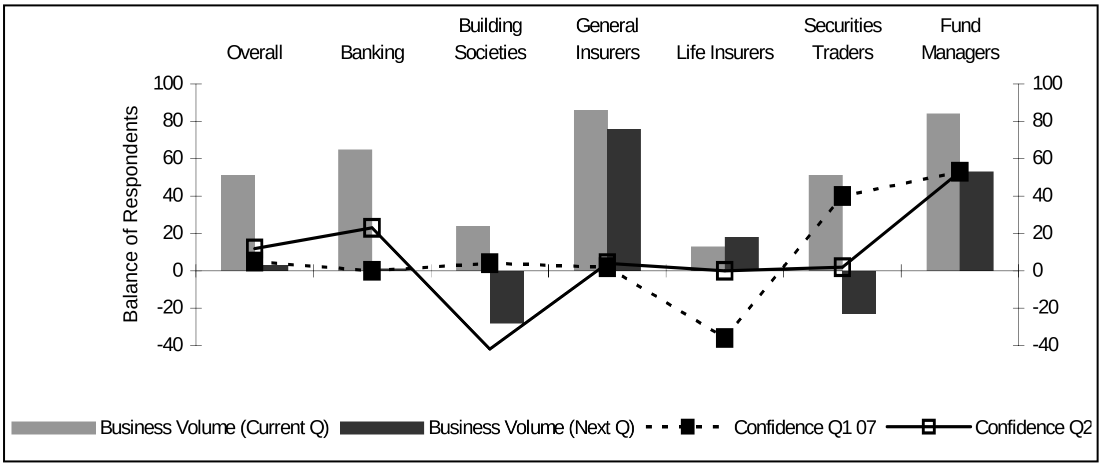
June 2007 – Number 71

"The highest aggregate increase in business volumes for seven years, although growth is expected to flatten out in the coming quarter"

The 71st CBI/PricewaterhouseCoopers financial services survey shows a notable improvement in the industry's overall confidence. This reflects the highest aggregate increase in business volumes for seven years, although growth is expected to flatten out in the coming quarter. Overall profitability is also expected to decline, due to greater pricing pressure, higher staffing and cost levels, and higher levels of delinquencies among the lenders. The overall picture also smoothes over some variations, with several sectors expecting marked changes in levels of activity in the coming quarter.

Nonetheless, most sectors seem reasonably confident about their future business prospects and all are pressing ahead with investment plans, especially for IT. Although greater efficiency remains the primary goal of expenditure, several sectors are now planning to expand their capacity and develop new services. Regulatory compliance is also a growing spending priority for all the major sectors, apart from banks and general insurers.

Figure 1: "The overall picture also smoothes over some variations, with several sectors expecting marked changes"



Merger & Acquisition prospects

This edition of the survey included topical questions about levels of financial services M&A, types of deal activity and the prospects for M&A for individual sub-sectors. Most respondents expect M&A levels to stabilise or continue growing, with in-sector consolidation the most likely driver of activity. Although some respondents expect activity between financial sectors, few seem to predict a major role for private equity or foreign bidders; this seems surprising, given the recent acquisition of Jupiter by PA Associates.

At a sub-sector level the building societies and life companies have the highest expectations for further M&A. Both banks and building societies, mindful of recent and active scale-building deals, predict further in-market consolidation. Life sector respondents are more likely to predict inter-sector convergence, perhaps reflecting the recent purchases of IFA networks by life companies.

General insurers and fund managers take a more balanced view of future M&A activity. For the insurers, this may point to the lack of recent deals (excluding the Lloyds market) and the sector's focus on distribution partnerships. In the fund management sector, booming volumes are encouraging players to remain independent; those that do expect further activity may be anticipating interest from banks searching for greater scale in wealth management.

Finally, interestingly, it is securities traders who take the most bearish view of future M&A activity levels.

Banking

A balance statistic of +23% of banking respondents are feeling more confident about their business situation, the sector's most positive response for two years. Nonetheless, while a balance figure of +65% report stronger volumes during the past three months, this is expected to level off in the coming quarter. A slowdown in retail mortgage lending is the most likely driver of this change, given that activity with personal customers is predicted to cool and that most banks have already seen a slow down in unsecured lending growth. In positive contrast, activity with financial institutions continues to be strong, reflecting the lending opportunities offered by M&A activity in the financial sector. Encouragingly for the wider economy, the banks also report a second healthy quarter of activity with industrial and commercial customers.

A review of the banks' responses on revenues reveals a mixed picture. Despite volume growth, income from fees and commissions fell; a balance statistic of -42% now expect further declines, with lower levels of new retail lending once again the most likely cause. Pricing competition also continues to affect revenue growth, with net interest income seen as declining and a large majority of respondents reporting downward pressure on spreads.

The banks continue to keep a tight rein on operating costs, thanks in part to their ongoing investment in IT-driven efficiency programmes. It is testament to their success in this area that costs have continued to decline despite further staff recruitment. Less positively, the value of non-performing loans (NPLs) was reported to have climbed for the seventh time in eight quarters, driven by higher consumer credit delinquencies. It is notable that while two thirds of respondents expect unsecured NPLs to remain stable, a third still predict higher levels of non-performance in the coming quarter. This split may reflect the fact that some banks were later than others in adjusting credit criteria as delinquencies began to rise. Given these divergent views, it will be interesting to see what the banks' half year results reveal.

Building societies

Building societies have returned to a pessimistic view, with a balance statistic of -42% feeling less optimistic about their business situation. This reverses the last quarter's temporary recovery in sentiment, and mirrors the slowing volumes of mortgage demand and pressure on margins currently being experienced by both banks and building societies. Although an increase in business volumes was reported, activity is now expected to decline and a balance statistic of -41% predict lower levels of business with retail customers in the coming three months. The sector's revenues are expected to follow a similar pattern, with the current quarter's modest improvements expected to be reversed over the next three months. This prediction anticipates a combination of slower business and stronger pricing pressure, as demonstrated by continuing downward pressure on average spreads. Pressure on margins has been exacerbated by recent interest rate rises. Nor are competitive effects limited to the asset side of the balance sheet, since several of the largest banks are now targeting retail savings more aggressively than at any time in the past few years. It is also notable that the value of non-performing loans continues to grow, although low loan-to-value ratios in most books mean that the actual value of arrears is unlikely to be material.

If the sector is understandably concerned by the prospect of a downturn in lending activity, then its responses to this situation also raise some questions. Costs continue to climb, both on an absolute and a per-transaction basis. The societies are still planning to expand their overall headcount, despite low reported levels of staff turnover and an expectation of falling volumes. A balance figure of +86% of societies are also planning to increase their IT investment spending; surprisingly, the provision of new services is cited as the most popular goal for expenditure. The combined effect of these cost pressures, falling spreads and higher non-performing loans is expected to keep sector profitability under pressure.

General insurance

The overall confidence of general insurers improved slightly for the second quarter running, with a balance statistic of +4% reporting greater optimism. The survey results showed several positive developments for the sector. Firstly, strong growth in business volumes continued for the third quarter running, with a balance figure of +86% reporting greater activity. Secondly, a majority of respondents reported healthier levels of activity with both commercial and retail customers for the first time in several quarters. And thirdly, a large majority also reported higher premiums, suggesting that despite some variations between risk classes, overall rates have remained stronger than had been expected.

These positive results encouraged general insurers to let their headcount levels and cost base rise during the quarter, with further expansion predicted for the summer months. Despite this, profitability was reported to have grown and is expected to stay on an upward trend. Another factor supporting profitability is the value of insurance claims, which was reported to have declined by a small balance statistic. If sustained, this will mark a notable turnaround from the experience of the previous two quarters. The decline in claims is probably due to an absence of major catastrophes over the past few months, along with actions taken by insurers to try and put some limits on claims inflation.

Given the broadly positive results outlined by the sector, it is tempting to ask why the headline confidence figure is so modest. The answer may lie in strengthening competition, which is highlighted as a likely limitation on business development by 96% of respondents. It seems that despite their confident responses to the survey, general insurers can't quite forget the cyclical nature of their business.

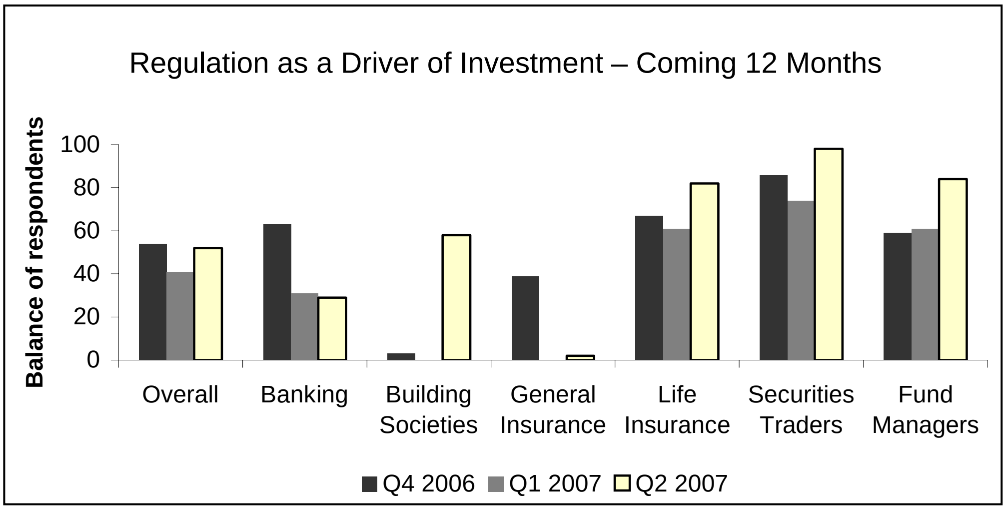
Life insurance

Life insurers return to a more balanced outlook after the previous quarter's dip in sentiment, reporting no change in their levels of confidence during the quarter. The sector's responses point to steady levels of customer activity, with solid retail custom a particularly welcome feature. New business is also reported to be on an upward trend, and when asked to look forward respondents make their most upbeat prediction for this area in over a year.

Even so, the full picture of the sector's responses is not as encouraging as the top-line data might imply. Profitability is emerging as an increasingly important concern for respondents, with a second successive decline being reported and a balance statistic of -65% now predicting a further fall, the most downbeat prediction in over fifteen years of survey data. An important factor is the level of surrendered contracts, which are reported to have increased in value for three quarters running. In line with anecdotal comments from the life companies, this gives a clear impression that policy churning is accelerating. A picture of increased churn is also consistent with the higher levels of headcount and total costs reported by the sector, since generating new business typically gives rise to both acquisition and administration costs. It is also notable that 81% of respondents now see expanding capacity as a motive for investment, compared with just 3% at the same time last year.

The pattern of higher volumes and falling profitability poses questions about the value of new business being written, especially at a time when the industry is looking increasingly well capitalised. Why might the sector prioritise market share over profitability? Among the largest players, a desire to maintain scale, market share and reputation is probably the most likely explanation. Still, it is interesting to ask what implications this has for the long-term performance of the sector, especially in the face of growing competition for long-term savings from banks and wealth managers.

Figure 2: "Regulatory compliance is also a growing spending priority for all the major sectors, apart from banks **and** ***general insurers"***



Securities traders

A balance statistic of +2% of securities traders report a further improvement in sentiment, building on last quarter's strong upswing in optimism. The sector appears to have enjoyed a successful quarter, with volumes of business and levels of income reported to have grown by a majority of respondents. This represents the third consecutive quarter in which the sector has outperformed its own predictions, although in this case expectations were clouded by the stock market correction of March. Even so, respondents still seem to be feeling jittery, with the balanced view pointing to lower volumes and a flattening out of income over the next three months. In the absence of any real market turbulence around the time of the current survey period, this uncertainty is best explained by concern over the levels of leverage in some recent M&A transactions, and the habitual market trepidation about market performance during the summer period.

The feeling of hesitancy among traders also manifests itself in several of their other responses. The sector does not have any significant plans to grow its headcount over the summer period, recording the lowest balance statistic for over three years when asked about future recruitment. The fact that respondents expect profitability to fall also suggests a lack of confidence about the sector's outlook.

Looking to the year ahead, regulation stands out as the sector's greatest worry and the primary driver of its capital expenditure plans. Respondents identify legislation and regulation as their primary concern for the first time, with 98% seeing it as a likely threat to their business over the coming twelve months. Regulatory compliance is also now viewed as the most important target for investment spending. This response makes it clear that compliance with MiFID will profoundly affect all securities traders. It also highlights the risk that MiFID could become a Trojan horse for the pet projects of IT managers throughout the industry, leading to unnecessarily high implementation costs.

Fund managers

A balance statistic of +53% of fund managers report feeling more confident, the first time in over a year that the sector has produced two successive quarters of greater optimism. The positive outlook is hardly surprising, given the consistently upbeat nature of the sector’s other responses. Volumes of business and the value of commissions were both reported to have grown by a balance figure of +84% during the past quarter, the strongest such responses since 2005. Costs and headcount were widely reported to have increased in response to this expansion, but this did not prevent a large majority of respondents from reporting increased profitability. Furthermore the positive trends in volumes, revenues and levels of profitability are predicted to continue into the summer months. Fund managers appear to be taking heart from a period of strong equity market performance, positive inflows and continued strong demand for their services.

Encouraging levels of customer activity are reflected in fund managers’ investment plans. Capital expenditure intentions for IT continue to trend upwards, with the need to expand system capacity a motivating factor for all respondents. The desire to develop new products and services is also cited as a driver of investment by the largest percentage of respondents since 2000. This reflects the sector’s ongoing investment in upgrading existing products and developing alternative propositions such as derivative-backed products for the retail marketplace. Looking to the year ahead, it is notable that concerns over a potential drop-off in levels of demand are at their lowest level for fifteen years. The only clouds on the horizon seem to be growing levels of competition, but so far these concerns are not sufficiently large to impact the sector’s positive outlook.

New economy

Financial services providers appear somewhat frustrated by the development of their Internet channels. Against a backdrop of several years of rapid growth in customer adoption - the average proportion of customers using the Internet has doubled since 2004 - the single-digit growth rates now being reported (in both the number of customers using the Internet to transact and the volume of business through this channel) are disappointing. At the same time, call centre usage levels are static, with roughly two-fifths of customers using call centres on average.

Given this stable picture, it is not surprising that three-quarters of respondents now cite customer preference for other channels as a critical barrier to further e-business adoption, the highest level ever recorded in this survey. Customer concerns about security and data protection also appear to have grown since last autumn in the wake of a number of high-profile security breaches, and three-fifths of respondents now cite these concerns as a critical barrier to further development, nearly twice as many as in December's survey. Few respondents are optimistic about future trends, with only a handful believing that the two major barriers will diminish in scale over the coming year.

Nonetheless, there remains a huge variation between companies within the sector. Roughly a quarter of respondents now operate solely through call centres or the Internet. These direct players continue to reap the benefits of lower transactional costs, but customer behaviour and regulations seem certain to preserve the importance of higher cost channels in other providers for the foreseeable future.

About this survey

The survey was carried out between 23rd May and 6th June 2007. A total of 70 companies responded including banks, building societies, finance houses, securities traders, fund managers, commodity brokers, private equity firms, insurance companies and insurance brokers.

If you would like to participate in the survey, please contact Jonathan Wood at the Confederation of British Industry (email: jonathan.wood@cbi.org.uk).

Further contacts

Copies of the full survey are available from the Confederation of British Industry, tel: 020 7395 8071, email address bookshop@cbi.org.uk. The price for a single quarter for members is £60 and for non-members £95; an annual subscription for members £210 and for non-members is £360.

For further information about this bulletin, please contact Max Harmer, PricewaterhouseCoopers on 020 7213 3571.

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