Financial Services Survey

CBI/PricewaterhouseCoopers Survey

Sharing insights and trends from the financial services industry*

September 2006

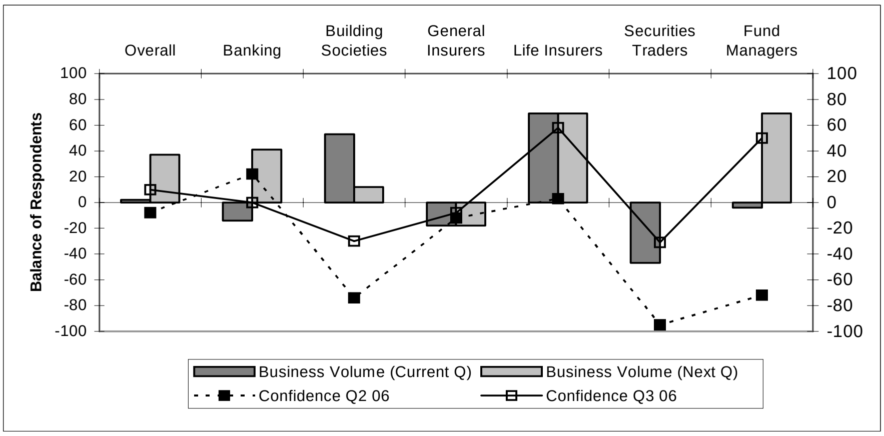
"As predicted in the previous edition of this bulletin, June's dip in confidence has proved to be short lived"

The 68th CBI/PricewaterhouseCoopers financial services survey shows the industry enjoying an improvement in confidence after last quarter's modest weakening in sentiment. As predicted in the previous edition of this bulletin, June's dip in confidence has proved to be short lived and while there is inevitable variation between sub-sectors, most areas of the industry remain positive in their outlook. Although several sectors reported disappointing levels of business during the quarter, most now predict further improvements in volumes of business. It is also notable that even the more pessimistic respondents such as securities traders are relatively sanguine about the broader prospects for business over the coming year.

The industry's cautious optimism has led to an aggregate increase in total levels of costs. Although the results show that headcount expansion is slowing, there is no sign that widespread reductions in staffing are planned. And while profitability was reported to have stabilised during the quarter, it is now predicted to expand by the largest overall balance statistic for six years.

Looking forward, a similar picture of confidence emerges. The industry is becoming less concerned about levels of future demand, and the need to reach new customers is reported to be an increasing driver of investment by most sub-sectors.

Figure 1: *"Although several sectors reported disappointing levels of business during the quarter, most now predict further improvements in volumes of business"*



*connectedthinking

Despite experiencing a quiet quarter, **banking** respondents report steady levels of confidence. A balance statistic of -14% saw volumes of business fall during the period, with the value of income also reported to have declined. The key driver of slowing revenues was the reduction in average spreads reported by a balance statistic of -42%. Pressure on spreads is nothing new for the banks, though current erosion is attributable not just to competition but also to mix effects as consumer lending growth slows. Nonetheless, the banks are confident that activity and income levels will recover in the coming months. A balance figure of +41% expect volumes of business to grow, and activity with retail customers is also expected to return to its long-term growth trend after an unexpected dip during the summer. A further welcome result is that custom with commercial customers has made a recovery after two quarters of disappointing activity.

After three consecutive quarters in which the banks reported growth in headcount and total costs, it is notable that numbers of staff are now reported to be falling, and that the sector is holding expenses flat on an absolute and per-transaction basis. This shows that cost control is firmly back on the agenda, and that the banks are once again focused on reducing back office costs after a period of investment in customer-facing activities. Profitability fell during the quarter, although the banks are confident that this will reverse as business recovers. One negative factor which is not yet expected to improve is the level of non-performing loans. This was reported to have grown by a balance statistic of +56%, the strongest response in 14 years. Growth in bad debts was widely reported at the interim results round, with unsecured consumer lending the major driver. However, there were also some signs that bad debts in the corporate arena are reverting to more normal levels after a period of exceptionally low losses. Overall though, the sector's habitual self-confidence is showing no signs of waning. Investment intentions continue to be positive, and the desire to reach new customers is as strong a driver of expenditure as it has been since 2001.

A balance statistic of -30% of **building societies** say they feel less confident about their business situation. This is the second consecutive quarter of decline, but as in June the sector's downbeat attitude seems to run contrary to the generally positive outlook for the mortgage market. Other survey results also give cause for encouragement, with volumes of business reported to have increased by a balance statistic of +53% and further improvements predicted. Activity with the all-important retail segment is also reported to be on an upward trend, as borrowers take heart from renewed growth in house prices. So what then is the root cause of the sector's gloom? The answer appears to lie in downward pressure on spreads, which is reported by a balance statistic of -47%. Despite stronger volumes of business, this erosion was sufficient to drive down the value of income, implying that the societies have been chasing volume at the expense of margins. However, it is interesting to see that average spreads are now predicted to rise, so it may be that the sector is planning a reversal of its recent tactics.

Building societies kept total levels of expenses steady during the quarter, and it is particularly notable that staff recruitment is expected to level off for the first time in four years. For this sector, these results represent an unusual level of focus on cost control. Another interesting result is that levels of non-performing loans are reported to be static. This confirms the impression that the growing credit losses experienced by the banks are being driven by consumer credit, not mortgages. It also suggests that recent media reports have overplayed the true level of arrears within the UK mortgage market. Despite their flat cost base and steady loss levels, the societies report their first decline in profitability since the start of 2005. Nonetheless, the sector's outlook for the future remains sanguine. The need to reach new customers has rebounded strongly as a motive for capital investment, and the number of respondents concerned about customer demand has reached its lowest level for over two years.

Confidence in the **general insurance** sector over the period continued to be weak as the balance statistic for overall business optimism remained in negative territory at -8%. General insurers have seen premiums decline and expect further erosion over the next three months. Whereas the responses in the June survey suggested that premium rates were peaking, the current survey indicates that the downswing has begun. A balance statistic of -40% of respondents have experienced a downward trend in overall profitability over the last three months, and the same number expect further downward pressure over the next three months. The experience of the last quarter disappointed many insurers, as in June a balance statistic of only -4% had expected a downturn.

Claims inflation has picked up and a balance statistic of +53% of respondents see an upward trend in claims costs over the next three months. Insurers have benefited from a generally benign claims environment in recent years as a decline in claims frequency has offset increases in average claim amounts. However there are indications that frequency declines can no longer be relied upon.

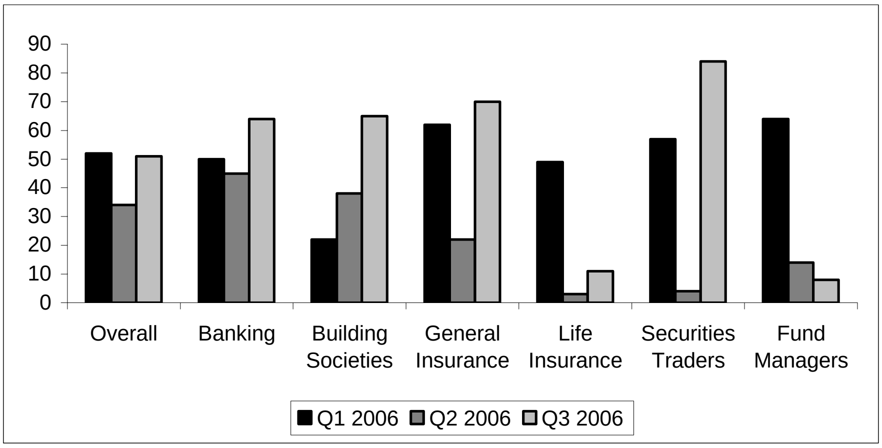
Marketing expenditure remains on a firm upward trend. Brand building is a priority and it could be argued that the expansion of direct sales channels is bringing much of the marketing expenditure that used to be carried by brokers in-house. Consistent with this, reaching new customers was cited by 70% of respondents as a driver of capital expenditure, up from 22% last time. Senior management has reacted to the downturn in the cycle by restricting capital expenditure or, in groups with other activities, directing it elsewhere. Shortage of finance and cost of finance were both cited by 62% of respondents as a limiting factor for capital expenditure, up from 8% and 12% respectively last time.

In contrast, **life insurers** have seen a sharp upward swing in confidence. The balance statistic for overall business optimism increased to +58% from +3% in June and a balance of +96% of respondents felt that overall profitability had increased. Clearly the major factors have been growing volumes of business and stronger stock markets. Pensions ‘A-day’ has been a major influence. New business growth, which had been forecasted at around 5% at the turn of the year, was subject to significant upward revisions over the early months of 2006 so that expectations now stand at over 10% for the year. Echoing this change, a balance of +69% say that volumes of business have improved, and a figure of +85% say that investment income is trending upwards. Pensions and unit-linked savings products are the major growth areas; and whilst these are lower margin products, indications are that product specific margins are improving as the industry benefits from scale effects. There has been concern that much of the new business is associated with ‘churn’, as older policies are surrendered. This looks to be true for the industry as a whole, but the major life insurers have seen strong inflows so the balancing outflows must be coming from smaller offices and, more particularly, the closed funds.

It is noticeable that employment is expected to decrease by a balance statistic of -63% whereas a figure of +95% expected an increase last time. The completion of IT investment projects, outsourcing and offshoring are all current features of the industry which may explain this change. As regards IT, a balance statistic of -36% expect reduced spending on IT over the next 12 months after many quarters of increasing investment. A balance statistic -32% now expect marketing spend to fall over the coming year. This is a reversal from a possibly ‘A-day’ influenced balance of +93% which had expected an increase in June.

Figure 2: Reaching new customers as a motive for investment

"The need to reach new customers is reported to be an increasing driver of investment by most sub-sectors"



Securities traders report a further decline in sentiment, with a balance statistic of -31% feeling less optimistic. Coming on top of the steep fall in confidence reported in the June survey, this result points to a sustained downturn in the sector's outlook. The predictions of falling volumes made in the June survey have turned out to be justified, with a balance statistic of -47% reporting declines in levels of business. The value of income also fell, both in terms of customer commissions and proprietary trading revenue. Levels of activity with the sector's most important customer segments were also reported to have declined. Private individuals stayed away from the market, intimidated by May's volatility, and key financial customers such as hedge funds were typically inactive over the summer period. Looking forward, there is little expectation of improvement in the sector's overall situation. Business volumes, income streams and customer activity are all predicted either to remain at their current levels or to decline further in the coming quarter. Given that the autumn is traditionally viewed as a strong period for the sector, that is a particularly downbeat assessment.

Despite their negative expectations, securities houses report further additions to their cost base and levels of headcount. Given the environment of falling revenues, this has unsurprisingly led to a decline in profitability. More worryingly, costs are expected to continue growing and no improvement in profitability is forecast for the next three months. However when asked to consider their plans for the coming 12 months, traders seemed slightly less despondent. Levels of demand were not identified as a long-term concern, and investment plans are increasingly focused on the expansion of capacity and the need to reach new customers. While traders see no reason to expect an imminent recovery in their fortunes, they evidently remain hopeful that their business will pick up in the medium term.

A balance statistic of +50% of **fund managers** report feeling more confident, a strong recovery after the last quarter's unexpected pessimism. Although stock market weakness in the early summer did lead - as predicted - to declines in business volumes and commission income, fund managers are now far more optimistic about their business prospects. A strong balance statistic of +69% predict volume growth for the autumn period, and good positive balances are also expecting income streams to swell. Furthermore, levels of activity are anticipated to grow across all customer segments, with a particularly strong upswing in the retail arena.

A quick look at the sector's operating environment shows why fund managers might be in a bullish mood. Stock market performance has improved; pension reforms and City bonuses are providing a useful stimulus to the supply of funds; and after a period of investment and innovation, most houses can now gather client funds into a far wider range of asset classes than two or three years ago. These observations are supported by the findings of PwC's latest Global Investment Management survey[1]. Of the sample surveyed (80 managers with £9 trillion of FuM), over half expect their revenues to increase by 20% or more over the next three years and only one manager predicted growth of 5% or less.

The sector's renewed confidence also shows itself in the cost line. Expenses are growing strongly, and profitability is also reported to be on an upward trend. In particular, a balance statistic of +96% say that headcount grew during the period, and that recruitment will continue to rise. Marketing expenditure too reaches a three year high, with a balance figure of +77% expecting to spend more in this area over the coming year. Taken together these results reflect fund managers' continuing focus on product innovation, distribution capabilities and staff specialisation. A final sign of confidence in the sector's prospects is the fact that the availability of professional staff is once again becoming a concern.

e-business

The digital divide highlighted in last quarter's survey remains apparent in this quarter's results. While the overall trend for internet use by customers is continuing ever upwards, the strong growth seen over the last year appears to have become more modest in the current quarter, with a significant minority reporting that customer adoption levels have not really changed. The most advanced companies continue to report that more than half of their customers transact with them online but at the other end of the scale, one in eight respondents say that less than 1% of customers make use of their internet services. Nonetheless, financial services companies continue to be positive about future trends in customer adoption. Predictions for adoption are similar to the actual rates of around 30% per annum experienced over the last three years. There is, however, little evidence of catch-up by those that are behind in Internet adoption. A third of respondents predict that less than 10% of customers will transact with them over the internet in a year's time.

Customer preference for other channels remains the single greatest barrier to further internet adoption. This seems a particularly stubborn issue, and respondents are not optimistic that any solution will be found over the next twelve months. In contrast, customer concerns over security appear to be falling back to more normal levels after a big rise at the last quarter. It seems that some of the messages from the Get Safe Online campaign[2] are starting to hit home with the public and ISPs, and financial services companies are providing more free security tools to their customers. Previous concerns about the speed of the internet and customers' unfamiliarity with websites now seem largely overcome, as broadband continues to spread into UK homes.

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[1] www.pwc.com/financialservices
[2] www.getsafeonline.org

Financial Services Survey

This bulletin is produced periodically to address important issues affecting the financial services industry. If any of your colleagues would like to be added to the mailing list or if you do not wish to receive further editions, please write to:

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About this survey

The survey was carried out between the 24th August and 6th September 2006. A total of 57 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.

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