

# the aqute angle

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A newsletter for the Financial Services Industry  
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***The Global Business Context – Challenges & Opportunities,  
Michael Foot CBE FCIB, MD Deposit Takers & Markets Directorate,  
Financial Services Authority***

Aqute attended the West-End Prestige Lecture hosted by the Institute of Financial Services (*ifs*) in London on the 7<sup>th</sup> May 2003.

Mr Michael Foot, FSA Managing Director of Deposit Takers & Markets Directorate, delivered a lecture entitled 'Global Economic Outlook & Implications for UK Banks'.

The key points from his presentation are summarised below.

## **Global Economy**

Looking at the EC forecasts for growth over the next couple of years, Mr Foot singled out the risks of war, global terrorism and SARS as being some of the challenges lying ahead. His expectation was for a very subdued world economy over the next 18 months to 2 years.

	<b>2003</b>	<b>2004</b>
World	3.2	3.7
US	2.4	2.5
UK	2.2	2.6
Euro area	1.0	2.3
Japan	1.5	1.3
Developing Countries	4.6	5.3

**Developing countries** – whilst the risk of SARS spreading to the developing countries is slim, SARS presents a major risk for Asia, the region forecast to provide significant growth. This is true in particular for populace countries such as India and Malaysia, where a regional SARS pandemic might take years to clear up. The region may therefore find its growth forecast heavily downgraded by the effects of SARS.

**Japan** – after 10 years of recession, Japan is still in a dire state and showing no signs of coming out of it. No significant growth is expected from Japan.

**Europe** – facing a sharp rise in the Euro, rigid labour markets and fiscal deficits close to the limits, will be hard put to achieve significant growth.

**US** – growth dependent on confidence returning to the market after the recent corporate financial scandals.

**UK** – the UK economy presents a rosier picture than most other economies, with a lot to draw comfort from in the current climate.

### Challenges to Equities from low inflation

The FTSE 100 Index figures for the last three years from 2000 to 2003, show poor performing equities brought on by low inflation. Only twice in the last century have there been consecutive drops such as this, the previous case being in 1930.

With interest rates of 2-3 % and growth at 2-3%, the UK cannot expect to get the double digits returns on equities that we have seen in previous years. Given these two factors, a return of 7-8% on average for an equities portfolio would be more in line.

The effect of poorer returns will be to place increasing pressure on costs in the financial markets.

Some of the challenges and issues presented by the current market:

- cohorts of younger people not saving enough, and who will present a problem at retirement age
- pension mis-selling, with the attendant £15billion cost of compensation
- mortgage endowment policies, possibly the greatest threat, with 4m policies not delivering enough capital to repay the mortgage
- split capital funds, £10-12billion at risk with the prospect of very large losses and law suits
- Precipice bonds, the most recent risk with £5billion capital at risk.

### Health of the UK Banking Sector

Reviewing a number of charts on the UK Banks, Mr Foot's assessment was that the UK Financial sector to be in rude health.

### Profitability and Capitalisation

In particular the graph on major UK-owned banks' Profitability and Capitalisation, showed UK banks' profit remained remarkably high with returns of 30% and improving capital profitability ratios. The British banking sector is in pretty good shape and has diversified well. A slight worry remains on the property market, but for the most part this risk has been transferred.

### Provisions and non-performing loans

Very healthy figures for NPLs and provisions over the last five years, show that the collapse of the Argentine loans only caused a 'ripple in the pond' and did not precipitate a major collapse.

### Mortgages and Loans

The mortgages market is a well diversified healthy market with over 4,000 products and intensive competition driving keen rates and flexible, better products than were available 25 years ago.

Debt - Statistics show 38% of families own mortgages of on average £40K. More worrying are the figures for non-mortgage debt, with 15% of families owning personal loans of £5,500, which is deemed high.

The chart on families finding it moderately difficult to difficult to meet debt repayments, showed that ¼ of family income going on mortgage debt servicing, whilst for the combined mortgage and non-mortgage debt this rose to 1/3 of the families' income. This could pose some very serious social problems for the 2.3m families that fall into that category.

## The Challenges and Opportunities Ahead

### Product Complaints

Complaint to the Financial Ombudsman often provide a good indicator of where the key problems lie in the financial services sector. Mortgage Endowment complaints have risen sharply in 2001-2002. Split Capital complaints are growing.

### Poor Numeracy

More fundamentally there is a poor understanding of financial products by the general public. Consumer education is poor and most lack understanding of the basics of numeracy. Tellingly, a recent survey showed that 40% of the adult population don't understand what a percentage is!

### Brand loyalty

With a bewildering array of financial products on the market, there is very little brand loyalty. This in turn drives competition on product features and price.

### Market uncertainty

#### Useful links

For a copy of the slides from Michael Foot's presentation, please email: [info@aqute.co.uk](mailto:info@aqute.co.uk)

To register with Aqute to receive our financial services newsletter, please reply to:

[admin@aqute.co.uk](mailto:admin@aqute.co.uk)

For further details of Aqute services, see our website: <http://www.aqute.co.uk/>

In the current uncertain markets, products need to be designed to be able to ride the markets at a reasonable price with a reasonable return. This is a challenge.

### **Savings**

There is still a huge way to go with the Savings market. The challenge remains with the younger generation, where the need to start saving early needs to be inculcated if severe problems at retirement are to be avoided.

### **Disclaimer**

The views in this newsletter represent the author's views on the events described herein and although every effort has been made to accurately describe them, may not be an accurate representation of the presentations given.

### ***About Aqute Limited***

Aqute, recently restructured from Ameritas, specialises in consulting to the financial services sector. Aqute management consultants have over 10 years experience in helping drive business change, business transformation and performance improvement with clients such as Royal Bank of Scotland, Zurich Insurance, Abbey National and Bayerische Landesbank.

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