

# *Industry sentiment*

## Financial Services Survey

*CBI/PwC quarterly  
survey measuring trends  
and providing insight from  
the industry*

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***The 87th CBI/PwC Financial Services Survey reveals a contrast between continuing optimism in some sectors of the industry and growing pessimism in others***

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## Executive summary

The 87th CBI/PwC financial services survey shows an overall picture of steady sentiment following several quarters of improvement. This picture conceals continued optimism in most subsectors of the industry, offset by emerging pessimism among bankers and securities traders. Demand, competition, regulation and political risks remain widespread sources of concern. In a welcome development, most subsectors report higher levels of employment.

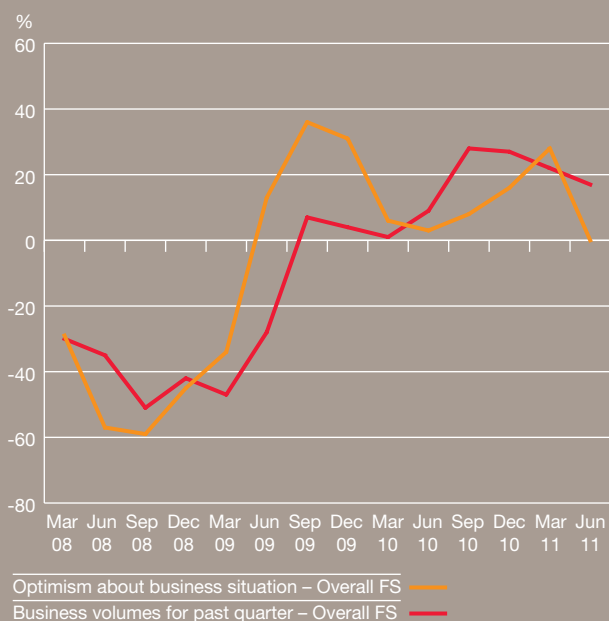
### Cooling industry sentiment conceals growing divergence between the subsectors

The growing confidence that has been a feature of UK financial services companies in recent quarters has stabilised, with aggregate sentiment returning to a neutral level (see Figure 1). This is chiefly the result of a slight decline in confidence among banking respondents, and a steep fall in optimism among securities traders (see Figure 2). In contrast, building societies, general insurers and

investment managers report increasing confidence, while life insurers maintain a more stable outlook.

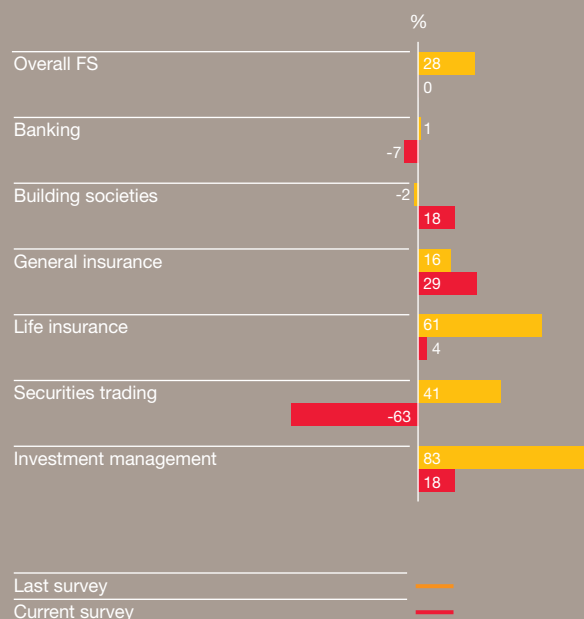
UK economic growth prospects have not changed significantly during the quarter, with consensus figures for GDP growth in 2011 declining only marginally and 2012 forecasts largely unchanged.<sup>1</sup> Instead, the lower confidence of banks and securities traders seems to be based on weakening volumes of business (see Figure 3). Both sectors report lower levels of activity for the quarter, and make even more downbeat predictions for the next three months. Competitive pressures also appear to be a concern for both sectors. Once again this is in contrast with other major subsectors of the industry, which are much more positive about their business volumes.

Figure 1: Optimism and business volumes



Source: CBI/PwC Financial Services Survey, June 2011.

Figure 2: Optimism about business situation



Source: CBI/PwC Financial Services Survey, June 2011.

The confidence of banks and securities traders is also being affected by other sector-specific factors. In the case of the banks, the interim report of the Independent Commission on Banking is a source of concern. Although the markets initially reacted to the interim report with a share price rally across the affected banks, closer study of the report suggests the final recommendations could be more onerous. Meanwhile, concern over systemic issues arising from a possible Greek default is overshadowing the securities traders, although the degree to which individual institutions may be affected by such an event is difficult to judge.

**More positively, the industry is allowing costs – and headcount – to grow again**

If the subsectors of financial services disagree in their assessment of top-line activity, they are in greater harmony when it comes to the cost line. With the exception of the building societies, all the major sectors are allowing total operating costs to rise. In some cases this marks the reversal of several quarters of expense reduction, suggesting a greater level of underlying confidence than the aggregate headline result would suggest.

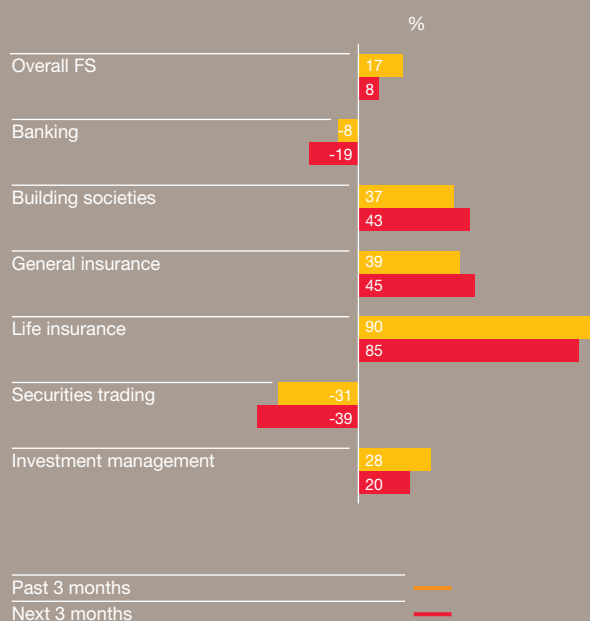
In a connected development, it is notable that numbers employed are seen as having grown across almost every sector of the industry (see Figure 4).

This is a very welcome finding after two quarters when aggregate levels of staffing were reported to have declined. The banks in particular appear to have reversed their position on headcount, although in part this reflects their plans for heavy spending on regulatory compliance.

When it comes to regulation, the survey produces some slightly conflicting responses. On the one hand, concerns about the effect of regulation on UK competitiveness appear to have eased since the last survey. On the other hand, there is no question that regulation remains a significant worry, and the aggregate balance of respondents expecting to spend more money on regulatory compliance is higher than it was in March.

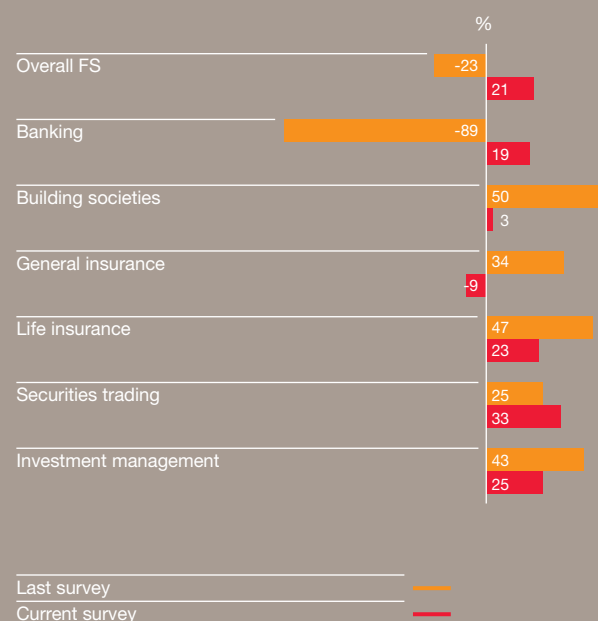
1 'Forecasts for the UK economy: a comparison of independent forecasts', HM Treasury, May 2011.

Figure 3: Trends in volumes of business



Source: CBI/PwC Financial Services Survey, June 2011.

Figure 4: Trends in numbers employed



Source: CBI/PwC Financial Services Survey, June 2011.

## ***Recent PPI issues are also keenly felt, and all respondents now expect to spend more on compliance during the coming year.***

### ***Banking***

**Banking confidence is declining, with the sector worrying about levels of demand and the effects of regulation, particularly the potential findings of the Independent Commission on Banking. Numbers employed are growing again, but so too is the value of non-performing loans.**

The banks report a slight decline in confidence, amid concerns about the pace of economic recovery and low levels of demand. For the first time since 2009, predictions for volumes of business are to the downside, and forecasts for retail activity have swung into negative territory. Respondents are still hoping for a recovery in commercial activity, but this has yet to materialise.

The banks are also unsettled by the current political backdrop. The sector's initial reaction to the Independent Commission on Banking's interim report was that the findings were not as severe as they might have been. However, concern about the implications of retail bank ring-fencing has grown as the current draft has been further analysed. While the details are yet to be worked through, banks are worried by the potential costs to customers and their

own ability to compete with international players not subject to the same requirements. Recent PPI issues are also keenly felt, and all respondents now expect to spend more on compliance during the coming year. Regulation is driving recruitment in finance and risk management, with the sector finally reported to be increasing its headcount after more than a year of decline.

With demand for skilled employees increasing, the availability of professional staff is seen as a growing limitation on business development. Although the banks' businesses are basically sound, respondents expect profitability to come under fresh pressure, reversing last quarter's bullish predictions. Non-performing loans are also reported to be increasing, ending several quarters of decline. Retail delinquencies are the key driver, suggesting that the effects of austerity measures and inflation are offsetting the benefits of low interest rates. Recent cost reduction announcements by a number of banks show the sector is well aware of the need to improve profitability.

## ***Building societies***

**Building societies are feeling more confident, suggesting that the sector has found a new equilibrium after several quarters of balance sheet shrinkage. In contrast to the banks, non-performing loans appear to be under control, but net interest margins remain under pressure.**

Building societies are feeling more positive than at any time since the end of 2009, with volumes of business, levels of income and retail demand all reported to be heading upwards. Combined with further increases in headcount and marketing expenditure, the overall impression is one of the most upbeat the sector has produced in recent quarters.

The consistently positive tone is in strong contrast with the dark days of 2008, when many societies appeared to doubt the sustainability of their business model. The balance of respondents who see levels of business as being 'below normal' is now at its smallest since 2007, suggesting that the sector may have reached a new equilibrium.

It is certainly true that several societies are emerging from a period of balance sheet shrinkage, and some are even managing to increase their levels of lending. Profitability is also seen as continuing to improve, even if most societies are making less money than before the financial crisis. Improvements in profitability are assisted by a fresh reported wave of cost reductions.

This is not to forget that the sector still faces significant challenges; not least, pressure on net interest margins. Respondents see a continuing squeeze on average spreads, driven by the drag of tracker products, requirements to hold more low-yielding financial assets than in the past and the pricing of retail deposits. The societies would welcome an increase in base rates, and the corresponding chance to boost net margins. All the same, low interest rates are helping to keep a lid on loan impairments. Non-performing loans are actually reported to have fallen by a small balance statistic, defying the gloomy predictions of most respondents in the last survey.

*The societies would welcome an increase in base rates, and the corresponding chance to boost net margins.*

## **General insurance**

**General insurers report increasing confidence, volumes of business and levels of premium income. Profitability has declined, but this is expected to be reversed as harder rates take effect.**

Last quarter's improvement in general insurance sentiment is accelerating, with a balance statistic of +29% of respondents now feeling optimistic about their business situation. Not only are volumes of business seen as having grown during the quarter, but nearly half of respondents predict they will expand further during the summer. Supporting this view, activity with all customer segments is reported to be increasing, marking a second successive quarter of growth across personal and commercial lines.

There is another side to insurers' improving mood. Premium income is reported to have increased by a balance statistic of +37%. This is the strongest result since 2007, and further

improvements are predicted for the coming quarter. This reflects a combination of pricing shifts, including a slight hardening of retail motor rates and an increase in reinsurance premiums following the Japanese tsunami and US spring storms. Profitability is seen as having fallen, the result of higher operating costs and increasing reported claims levels. However, this is expected to reverse during the coming months as harder rates take effect.

Despite their upbeat views on premiums, when asked to assess the year ahead, respondents clearly identify domestic competition as their greatest concern. The sector remains keen to develop its international operations, although the low substitutability of general insurance products means that the threat from other sectors is consistently low. General insurers are also less concerned about the effects of regulation than many other subsectors of financial services. This is no surprise, given that most are likely to find the effects of Solvency II more manageable than their counterparts in the life sector. Even so, a clear majority of respondents expect to spend more on regulatory compliance during the year ahead.

***The sector remains keen to develop its international operations.***

## ***Life insurance***

**Life companies continue to report strong levels of business. In another sign of confidence the sector is allowing costs to rise. However, the prospect of the Retail Distribution Review is creating some uncertainty over future patterns of demand.**

After recording a strong surge during the first quarter of the year, life insurance sentiment has stabilised. This does not alter the fact that volumes of business are still seen as increasing by almost all respondents. New business is on an upward trend too, with a balance statistic of +85% predicting further improvement in the coming quarter. Activity continues to expand across all customer segments, with demand from private individuals seen as being particularly strong.

If revenue trends are largely unchanged, the same cannot be said for the expense line. Total operating costs are reported to have increased by a balance statistic of +38%, the first positive figure since 2007. The increase in volumes means that average costs are still seen as declining, albeit by a much smaller

balance of respondents than before. Numbers employed are reported to have expanded again, ending the headcount reduction of 2009. Marketing and capital expenditure are also growing. The clear implication is that life companies have decided to ease spending restrictions, although it is notable that training expenses are not seen as expanding in line with staffing levels.

Despite the overwhelmingly positive tone of the survey, life companies are clearly worried about competition and levels of demand; both are identified as a concern by more than 90% of respondents. The Retail Distribution Review is not an immediate threat to business, but it is generating uncertainty over future patterns of demand. Life insurers' views on potential sources of competition suggest that the coming shake-up will have an impact on the broader savings market by increasing competition from banks and investment managers. Regulation also remains a concern, with the prospect of Solvency II continuing to drive growth in compliance spending.

*Activity continues to expand across all customer segments, with demand from private individuals seen as being particularly strong.*

## **Securities trading**

**Securities traders report a steep decline in sentiment, based on falling volumes of business and a weak reported outlook for the sector's key income streams. Lower levels of profitability are also a source of concern, with traders facing strong competition in their core markets.**

Securities traders are by far the least confident of any of the major subsectors of financial services, with a balance statistic of -63% of respondents feeling more pessimistic about their business situation. This deterioration is mirrored in the sector's volumes of business, which are reported to have fallen for the first time in five quarters. For the first time in two years, securities traders also report a decline in both commission and trading income. Concerns over a possible default on Greek sovereign debt are likely to be fuelling concern, although factors including a hesitant IPO market are also important.

It therefore seems more likely that traders have taken a fresh look at their situation and, as a result, reined in the optimism of recent surveys. One factor is increasing competition. It is notable that respondents have become more sanguine about average spreads, which were reported to be expanding during the second half of 2010. Profitability is another consideration. An increase in total operating costs during the quarter has combined with disappointing volumes of business to push down profitability for the first time in a year.

Levels of demand are also identified as a concern by securities traders considering their prospects for the year ahead. For the first time in almost two years, all respondents see demand as a potential limiting factor on business. When asked about sources of growth for the coming quarter, 42% also say they expect no growth at all, the highest such figure since the question was introduced at the start of 2009.

*For the first time in almost two years, all respondents see demand as a potential limiting factor on business*

**Throughout the responses to the survey there is a continuous thread of concern about business volumes, levels of demand and competition.**

## **Investment management**

**With competition for retail investors remaining intense, investment managers' expectations for income are stuttering at a time when costs are increasing. All in all, respondents predict a bleaker outcome for the sector, with profitability predicted to come under pressure.**

Investment managers have seen net retail sales decline significantly over the last eight quarters.<sup>2</sup> During this period the sector has faced intense competition within the UK from savings and deposit accounts offered by the retail banks and building societies. The previous three surveys have shown investment managers looking to private individuals to drive growth in activity, but while April saw the usual burst of pre-tax year-end business, recent net retail inflows do not seem to have matched those levels of optimism.

As a result, the rate of improvement in investment managers' confidence has slowed significantly, in contrast with the two previous quarters of strongly positive sentiment. On the income side, expectations are lower across the board, from volumes of business to fee and commission income and levels of investment and trading income. Given that overall operating costs are predicted to expand by a strong balance of respondents, it is therefore not surprising that the sector's forecast for overall profitability has fallen from a balance statistic of +87% at the last quarter to just +5% in the current quarter. Despite the concerns about profitability, the industry is still positive on employee numbers, staff training and overall staff costs. Prior concerns about staff turnover and the availability of professional staff appear to have abated.

Throughout the responses to the survey there is a continuous thread of concern about business volumes, levels of demand and competition – both from traditional players and new entrants. This concern is driving a focus on core customers and core domestic markets; only time will tell whether these efforts will reverse the recent trends on profitability.

<sup>2</sup> 'Investment fund statistics – April 2011', Investment Management Association, 06.06.11.

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

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### ***About this survey***

The survey was carried out between 25 May and 9 June 2011. A total of 104 companies responded, including banks, building societies, finance houses, securities traders, investment 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](mailto:jonathan.wood@cbi.org.uk)).

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