

# *Industry sentiment*

## Financial Services Survey

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

*Issue number 88  
September 2011*

***The 88th CBI/PwC Financial Services  
Survey shows industry confidence  
beginning to fall, despite continuing  
revenue growth in several sectors***

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## Executive summary

The 88th CBI/PwC financial services survey shows industry confidence falling for the first time in over two years. This reflects increasing concern over the macroeconomic and political situation. In contrast, the industry continues to report steady – albeit cooling – revenue growth. Plans for headcount reduction are gathering pace, but so too are growth plans focused on the acquisition of domestic customers.

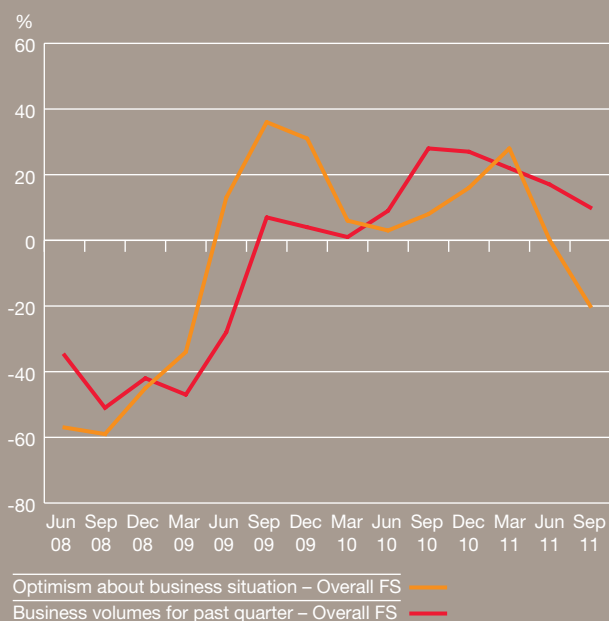
### Headline confidence has begun to fall, despite continuing growth in volumes of business

After stabilising in June, the increasing confidence that UK financial services companies had reported since mid-2009 is now seen as having reversed. In contrast, the industry reports that aggregate volumes of business continue to expand, albeit at a slower rate (see Figure 1). Revenue growth is also reported to be cooling, but this varies

between sub-sectors and there is no suggestion of an impending industry-wide slowdown in levels of income.

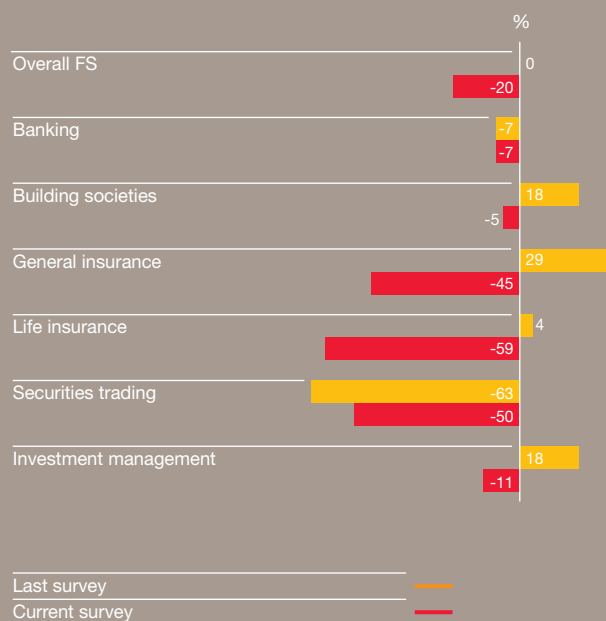
Different sub-sectors of the industry are experiencing a wide variation in financial performance. Some report improving profitability, while others – most notably general insurers and securities traders – point to a much weaker bottom line. Once again though, the picture is overshadowed by falling sentiment. The insurers have undergone a particularly marked deterioration in confidence, but it is notable that every major sector now takes a pessimistic view of its business situation (see Figure 2).

Figure 1: Optimism and business volumes



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

Figure 2: Optimism about business situation



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

**Political and economic factors underpin the decline in sentiment**

The deterioration in industry sentiment is explained by three key factors. The first two are uncertainty about the weakening prospects for UK and European economic growth rates,<sup>1</sup> and concern about the increasing impact of national and international regulation on the industry. The third factor, the European sovereign debt crisis, will have become even more important since the survey period of late August and early September.

Even at the time of our survey, unease over the likelihood of a resolution to the crisis was mounting, and respondents were considering its potential effects on confidence and growth. It is notable that the number of respondents who

see a high likelihood of further deterioration in the financial markets increased for the second quarter in a row (see Figure 3).

**Most sectors predict headcount reductions, but customer acquisition plans are also afoot**

Just as assessments of profitability vary across the industry, so too do attitudes to cost management. Aggregate levels of expenses are seen as remaining flat, but some sectors are allowing costs to rise while others seek to pare them back. It is striking that most sectors of the industry expect to reduce their headcount during the autumn months (see Figure 4), reversing the more upbeat predictions for employment made at the last survey.

Looking to the year ahead, it is no surprise that regulation remains a major driver of ongoing expenditure and capital commitments. More encouragingly, there are also some signs that the industry is looking to invest in marketing and distribution, in a bid to acquire new domestic customers and offset any further reductions in revenue growth.

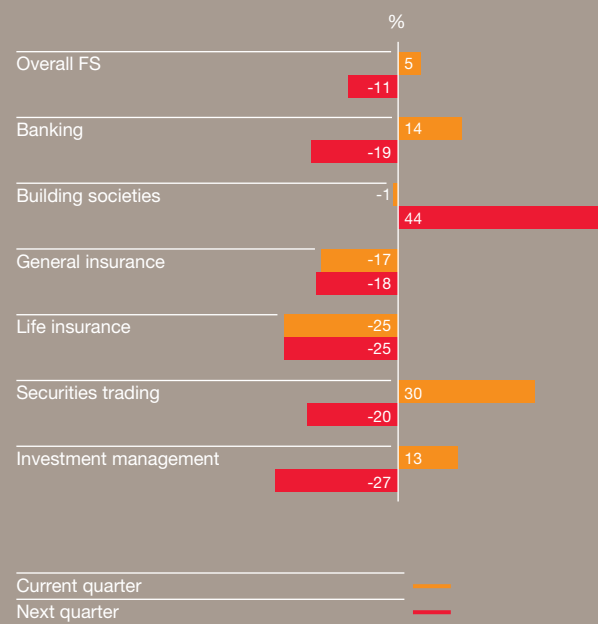
1 'Forecasts for the UK economy: a comparison of independent forecasts', HM Treasury, August 2011.

Figure 3: Likelihood of market deterioration



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

Figure 4: Trends in numbers employed



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

## ***Predictions for activity with both retail and commercial customers have improved since June.***

### ***Banking***

**Despite reporting a solid quarterly performance, the banks' sentiment continues to be overshadowed by concerns about levels of demand and new regulation. Margins and overall profitability appear to be holding up, but the sector is considering fresh reductions in headcount.**

Banking sentiment continues to be affected by economic concerns and the weight of regulation facing the sector, pushing headline confidence into negative territory for the second consecutive quarter. In contrast, short term performance is seen as holding up better than had been expected. Revenues are reported to have grown during the quarter, and a small balance of respondents expect income to expand further during the autumn. Predictions for activity with both retail and commercial customers have improved since June, and the value of non-performing loans remains controlled. Overall profitability is reported to have strengthened, with no sign of fresh pressure on average spreads and relatively little concern over competitive threats.

Those surveyed expect a short term increase in operating costs, but given the efficiency programmes announced by several banks in recent months this seems unlikely to persist. The banks continue to invest in IT, with efficiency gains identified as the leading rationale. There is also fresh interest in headcount reductions, although the availability of professional staff remains a concern.

The Independent Commission on Banking's final report – published just after the end of the survey period – is clearly affecting the sector's outlook. Unsurprisingly, respondents continue to see regulation as a driver of expenditure, but the real significance of ring-fencing comes from its anticipated effect on balance sheets and business models. The potential effect of higher costs is evident from respondents' concerns about the impact of regulation on business growth. Banking respondents are also particularly concerned about the impact on the UK's international competitiveness.

## ***Building societies***

**Despite ongoing margin pressure, building societies report one of the more positive sets of survey results. Respondents predict an autumn of growing business and higher headcount. For now, low base rates seem to be keeping non-performing loans under control.**

Following a notable improvement in confidence in June, building societies' sentiment has remained relatively stable. Despite the persistent view of some respondents that current levels of business are still below normal, those surveyed make surprisingly positive forecasts for volumes of business and the value of revenues. Notably, retail demand is predicted to generate fresh momentum during the autumn.

In another pleasant surprise, overall profitability is reported to have increased during the quarter. This was achieved in spite of a fresh decline in average spreads, reported by a balance statistic of -98% of respondents. The explanation lies in further reductions in

the societies' operating costs, which helped to offset the effects of tighter spreads. Profitability also received a boost from an additional decline in the value of non-performing loans, and the societies expect spreads and overall profitability to remain steady over the coming quarter. It is true that many economists expect base rates to remain low for the rest of the year, but it is worth remembering that the societies could still be exposed to higher impairments when standard variable rates begin to rise.

The societies are now the only major sub-sector of financial services planning to increase their numbers employed. A balance statistic of +96% also expect to commit more capital to IT during the year ahead. These planned investments are consistent with the sector's growth plans, which focus almost exclusively on retaining existing customers. IT systems and applications are seen as critical to achieving this aim. A number of societies are focusing on developing their customer-facing capabilities, such as upgraded CRM systems and online savings accounts.

*In another pleasant surprise, overall profitability is reported to have increased during the quarter.*

## **General insurance**

**Sentiment in the general insurance sector has gone through an about turn, with respondents making downbeat forecasts across a range of business indicators. In response, measures intended to boost customer acquisition are receiving greater priority.**

Optimism among general insurers seems to have evaporated, with the sector reporting a striking downturn in sentiment from a balance statistic of +29% in June to -45% in the current survey. Anticipated improvements in premium income have not materialised, suggesting that hoped-for rate rises have not taken hold in the market, and personal lines are seen as having stagnated. Business with overseas customers is also reported to have fallen. It is too early to know whether this indicates a genuine decline in demand, but it is a potentially significant response considering the sector's increasing dependence on foreign markets for growth.

General insurers do not only see revenues weakening, they also report an unexpected decline in overall profitability. This reflects several factors including the recent run of natural catastrophes and the increasing value of claims, which is reported by a large majority of respondents. Forecasts for profitability are relatively neutral, but it remains to be seen what the effects of the government's intention to ban referral fees – announced at the very end of the survey period<sup>2</sup> – might be.

Lastly, there is growing concern about the medium term outlook. The weight of respondents identifying levels of demand as a limitation on business has doubled since June. In response, the acquisition of new customers is being given greater priority, along with investment in related sales and marketing capabilities. Even so, the fact that insurers are expecting to reduce their headcount for the first time in over a year could make this a challenging target.

*Forecasts for profitability are relatively neutral.*

<sup>2</sup> *Minister condemns insurance 'racket'*, Financial Times, 09.09.11.

## Volumes of business and the value of revenues continue to grow.

### **Life insurance**

**Life insurers report a steep drop in confidence, amid concerns about the outlook for new business. However, profitability and other key measures of performance are more encouraging. The life companies are reducing operating costs, but also plan to invest in new products and services.**

Like their counterparts in general insurance, life companies report a very strong downward swing in confidence. Headline sentiment has fallen to a balance statistic of -59%, the lowest figure since 2008. However this looks something of an over-reaction, given life insurers' more moderate responses to much of the rest of the survey.

Volumes of business and the value of revenues continue to grow, albeit at a slower pace than expected. Assessments of customer activity also show no sign of slowing domestic demand.

Instead, the most likely explanation for life insurers' lower headline confidence lies in predictions for new business, which have fallen into negative territory for the first time in two years. A third of respondents also expect the value of new business to fall over the next three months. These forecasts probably reflect anticipated cooling in the term insurance market, which is comparatively sensitive to slower housing market activity and lower levels of disposable income. In response, life insurers highlight a number of potential growth strategies.

These include investment in distribution, strategic partnerships and new products, with a view to boosting the appeal of the sector's customer proposition.

Having allowed costs to rise when business was expanding, the life companies have begun to rein in their spending. Operating costs and numbers employed are reported to have fallen, with further reductions expected for the coming quarter. It is also notable that regulatory spending is predicted to cool slightly, as firms defer some of their IFRS compliance. As a result overall profitability is seen as having increased, and is expected to remain steady over the autumn despite the anticipated fall in new business.

## **Securities trading**

**Securities traders' sentiment remains negative, despite a strong trading performance. Uncertainty over sovereign debt markets continues to cloud the sector's outlook. Headcount reductions are planned, but regulatory spending is pushing up costs, bringing profitability under pressure.**

Securities traders report another quarter of strongly negative sentiment, with a balance statistic of -50% feeling pessimistic about their business situation. Traders continue to see a risk of greater market turmoil, even if it has yet to fully materialise. In fact the sector had a more successful summer than expected, with volumes of business growing strongly during the quarter. Trading income grew strongly, with equity and bond markets experiencing some of their busiest ever days in the wake of the US downgrade and other sovereign debt related announcements.<sup>3</sup>

Nonetheless, there is no question that unease about the medium term outlook continues to hang over securities traders. Many in the industry expect the ongoing European sovereign debt crisis to gradually slip into more dangerous territory. It is these fears that have led increasing numbers of IPOs to be pulled in recent months,<sup>4</sup> and the same concerns are behind respondents' comparatively downbeat predictions for volumes and revenues. Levels of demand from private individuals and overseas customers are also predicted to decline during the autumn.

As predicted, securities traders allowed their headcount to increase during the quarter, but numbers employed are now expected to decline. Even so, operating costs are predicted to increase and all respondents expect to spend more on regulatory compliance during the year ahead. The overall result is that profitability has declined and is forecasted to fall further. Regulatory compliance is also identified as the leading motive for capital expenditure as traders begin to consider the impact of the MiFID review and EMIR.

## **Trading income grew strongly.**

<sup>3</sup> *Trading volumes hit record levels*, Financial Times, 10.08.11.

<sup>4</sup> *Volatility scuppers flotation plans*, Financial Times, 09.08.11.

## **Investment management**

**Investment managers' sentiment is now negative for the first time in over two years, although current performance is reported to have held up surprisingly well. The sector has tightened its grip on costs, and respondents plan to reduce numbers employed during the coming quarter.**

*Investment managers also show a greater readiness than before to respond to weaker top-line performance with tighter control of operating costs.*

Investment managers' headline sentiment has declined to a balance statistic of -11%, the first negative response since equity markets began their rally in March 2009. Given the volatility and steep falls of equity markets over the summer, this is perhaps not as bad a result as might have been expected.

In the same way, the fact that respondents see revenue growth as having stabilised – but not reversed – seems surprisingly positive in the current market. The fact that retail activity is reported to have remained steady over the summer is particularly welcome, considering July's extremely weak figures for net retail fund sales.<sup>5</sup>

True, levels of demand and the intensity of competition are identified as growing concerns, but the sector is remaining notably calmer than during many previous market corrections. Forecasts for the coming quarter point to steady revenues and a stable outlook for overall profitability.

Investment managers also show a greater readiness than before to respond to weaker top-line performance with tighter control of operating costs. Growth in the sector's expense base is reported to have come to an abrupt halt, and there is an expectation that the coming quarter will see the first headcount reductions for over two years. Capital investment in IT continues to grow, with a particular focus on increasing capacity and improving efficiency – responses that could point to a fresh wave of outsourcing. However, given the sector's regulatory environment it is surprising to see that compliance spending is seen as a lesser priority than at any point during the past year.

<sup>5</sup> IMA statistics reveal slowdown in July Net Retail Sales, IMA, 05.09.11.

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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 is £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 23rd August and 8th September 2011. A total of 84 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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Design & Media – The Studio 20869 (10/11)



Printed on paper manufactured in the EU containing recycled fibre.



