

Financial Services

# Financial Services Survey

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

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## Executive summary

The 83rd CBI/PricewaterhouseCoopers Financial Services Survey shows a gentle further improvement in confidence and levels of activity, but with increasingly upbeat predictions for the coming quarter. Other encouraging signs include plans to expand headcount and an expectation that non-performing loans will start to fall. On the downside, regulatory costs are rising fast and respondents are concerned about further deterioration in the financial markets.

### Confidence continues to edge up, with stronger activity widely predicted

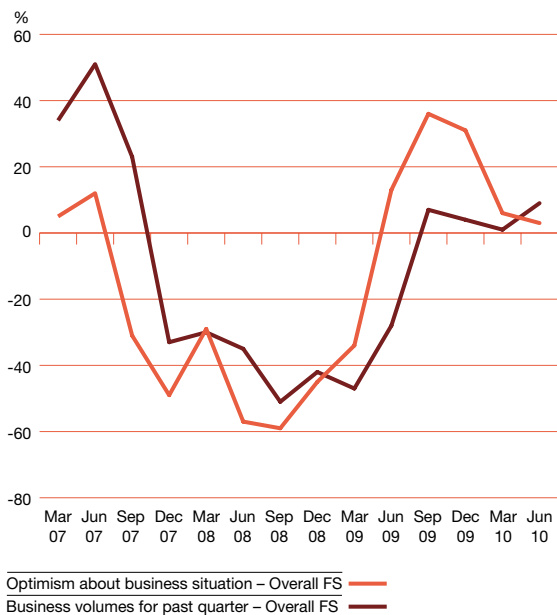
The survey shows a slight further improvement in UK financial services sentiment, meaning that is now a full year since the industry returned to a positive outlook. Overall volumes of business also recorded their fourth consecutive quarter of growth (see Figure 1), although the recovery in business remains tentative.

Nonetheless, the industry is increasingly confident that a pick-up in activity is just around the corner. An aggregate balance statistic of +63% now predicts stronger business volumes for the coming

quarter, the strongest such response the survey has produced since 1993. This confidence is driven by upbeat predictions from several sub-sectors including banking, life insurance, securities traders and investment management (see Figure 2). Of the major sub-sectors, only building societies and general insurers strike a less positive note.

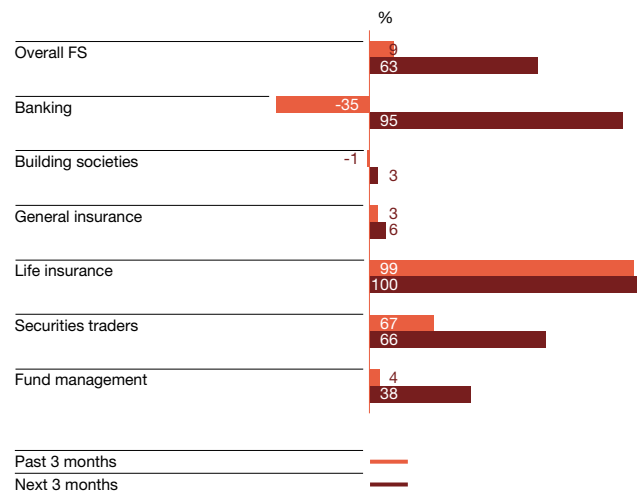
In other encouraging signs, overall predictions for customer demand are among the most positive seen in recent years, marketing intentions are generally strong and recruitment plans have returned to positive territory for the first time since 2007.

Figure 1: Optimism and business volumes



Source: CBI/PricewaterhouseCoopers Financial Services Survey, June 2010

Figure 2: Trends in volume of business



Source: CBI/PricewaterhouseCoopers Financial Services Survey, June 2010

### Non-performing loans are now predicted to decline, but compliance costs are rising fast

A more mixed picture emerges from a look at the industry's cost base. On aggregate, operating expenses continue to fall, but this conceals wide variation between sub-sectors. Overall profitability is also seen as moving in the right direction, but this too glosses over the steep declines in profitability reported by general insurers and securities traders. The fact that non-performing loans are now predicted to decline for the first time in five years is, however, a highly welcome development for lenders.

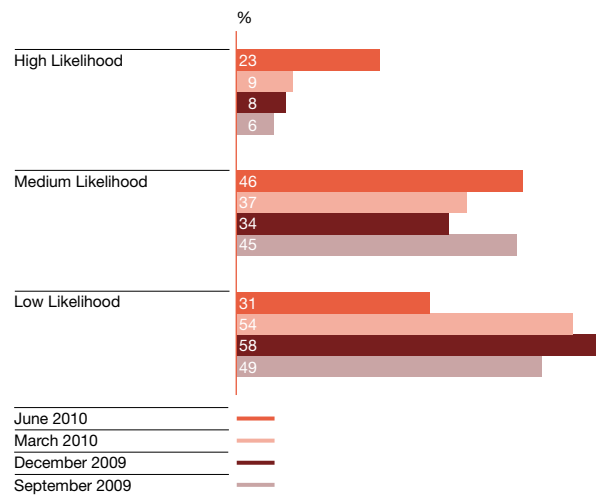
Regulatory compliance is becoming a universal concern across UK financial services, with all major sub-sectors expecting to spend more on this area during the coming year. This is hardly a surprise: although the survey was conducted before the Chancellor's Mansion House speech announcing broader powers for the Bank of England,<sup>1</sup> the industry was already facing a range of regulatory initiatives including Solvency II, UCITS IV and the Retail Distribution Review. It is clear that compliance is becoming an increasingly significant element of the industry's cost base.

### Uncertainty still lingers; financial market disruption is now a growing concern

For all that the industry's short-term forecasts are becoming increasingly upbeat, the survey reveals lingering uncertainty about the medium-term outlook. Concern over levels of future demand remains high, with many in financial services unsure what the economic effects of a wind-down in fiscal or monetary stimuli might be.

Concern over levels of European sovereign debt<sup>2</sup> has further sharpened minds on the state of UK public finances,<sup>3</sup> as well as reminding the industry of the disruptive capacity of the financial markets. In fact, respondents' views of the likelihood of a further deterioration in financial market conditions have increased markedly (see Figure 3), reaching their most pessimistic view in more than a year.

Figure 3: What do you consider to be the likelihood of further deterioration in financial market conditions over the next six months?



Source: CBI/PricewaterhouseCoopers Financial Services Survey, June 2010

1 'Osborne abolishes FSA and boosts Bank', Financial Times, 16.06.10.  
2 'Special vehicle fails to drive away Sovereign debt unease', Financial Times, 01.05.10.  
3 'UK Economic Outlook', PricewaterhouseCoopers, March 2010.

## ...the value of non-performing loans is expected to decline by the largest balance statistic since 2005.

### Banking

**The banks report a generally positive picture of growing revenues and profitability, falling costs and lower impairments. The sector's neutral sentiment might seem surprising, but it reflects uncertainty over the eventual outcome of regulatory proposals and the prospect of a new industry levy.<sup>4</sup>**

Banking sentiment remains steady for the second quarter running, a result that looks surprisingly neutral given the generally upbeat picture painted by the survey. True, levels of business are reported to have declined again, but a remarkably high balance statistic of +95% is now expecting activity to pick up. Fees and commissions are reported to have increased, and there are positive predictions for interest and non-interest income alike. Notably, levels of demand are reported to have grown across all customer segments for the first time in three years. The fact that a balance statistic of +74% now expect stronger demand from industrial and commercial companies is a particularly encouraging sign.

The banks' responses on costs and profitability also give a positive impression. Overall profitability remains on an upward track, and staffing expenses are expected to fall despite stronger hiring intentions. In part, this can be explained by the considerable use of short-term contract staff by banks over the past two years, especially in corporate and investment banking. Now that business is expected to recover, these roles are being increasingly filled with permanent staff. In another sign that the banks feel they have put the worst behind them, the value of non-performing loans is expected to decline by the largest balance statistic since 2005.

Considering the banks' positive views of their own performance, why is their sentiment relatively subdued? The most likely answer is that the banks are less confident in their operating environment than they are in their own business models. There is uncertainty over future levels of demand, competition from new entrants, the economic impact of the withdrawal of fiscal stimulus, the intentions of the FSA and the possibility of political intervention in the industry.<sup>5</sup> As a result, cross-selling to existing customers remains the focus for growth, while – for the first time in the survey's 20-year history – a full 100% of respondents identify legislation and regulation as the largest probable limitation on business development during the year ahead.

### Building societies

**Building societies continue to face weak demand for their core products and a challenging funding environment. More positively, non-performing loans are expected to decline and the sector is planning to attract fresh customers and develop new products.**

Sentiment among building societies is stable, but the increase in volumes reported during the first quarter has fizzled out and respondents remain adamant that levels of business are 'below normal'. Given that the Council of Mortgage Lenders is predicting net lending in 2010 will be more than 80% lower than in 2007<sup>6</sup> – and that there could even be downside risks to this figure – perhaps it is time for the sector to revise its definition of normality.

Funding remains an acute issue for the societies, identified by more than 90% of respondents as a potential limitation on business. Competition for retail deposits remains fierce, and the sector is still looking for a new way to raise loss-absorbing equity, since the Permanent Interest-Bearing Shares (PIBS) issued by many societies do not carry Tier 1 capital status. Hopes that a new type of capital instrument resembling a bond, but counting towards core regulatory capital, could soon be approved by the FSA<sup>7</sup> appeared to have stalled. Until such an instrument has been approved and tested in the market, long-term funding is likely to remain a challenge.

Even so, not all of the societies' responses are gloomy. It is particularly encouraging that the value of non-performing loans is expected to decline for the first time since the end of the housing boom. It is also notable that almost all respondents plan to increase their marketing expenditure. This is matched by a strong desire to attract new customers, and an increasing interest in launching new products. In the savings arena, this is likely to mean improving time to market. On the lending side, it could involve tailoring products for particular customer groups. This is unlikely to generate large volumes, but it should produce better returns than prime vanilla lending.

4 'Bank levy seen as threat to City jobs recovery', Financial Times, 15.06.10.

5 'Banking Banana Skins 2010: After the quake', CSFI, February 2010.

6 'CML warns of downside risk on lending forecasts', Council of Mortgage Lenders, 02.06.10.

7 'Mutuals close to capital deal', Financial Times, 15.02.10.

## General insurance

**General insurers have returned to the positive view they held for most of 2009. However, the underlying metrics are less encouraging, with respondents pointing to declines in premium income and overall profitability. Costs of regulation are increasing rapidly.**

General insurers report a return to the optimism of last year, reversing the slightly negative sentiment evident at the last survey. Even so, this improvement is not entirely supported by insurers' other responses. Volumes of business and customer demand are seen as remaining relatively neutral, although this is an improvement on March's strongly negative figures. The value of premium income is also reported to have declined by a balance statistic of -60%. This probably reflects pricing in commercial lines, where rates are showing some signs of trending downwards. In contrast, personal lines pricing is holding up quite well and some companies are managing to achieve rate rises in core products such as home and motor.

As predicted, the value of insurance claims has begun to trend upwards, although it is worth remembering that this figure is coming from a low base. More encouraging is the sector's continued focus on cost reduction, aided by comparatively steady levels of headcount. Even so, profitability is reported to have declined for the third quarter in a row, with a further decline predicted for the summer months. As discussed in the last edition of this bulletin, many in the sector expect higher customer churn, weaker investment returns and a tougher claims environment to put profitability under pressure during 2010. Regulatory spending is evidently another area of concern. A balance statistic of +79% of respondents expect costs of compliance to rise, driven chiefly by the inexorable approach of Solvency II.<sup>8</sup>

It is notable that insurers' predictions for domestic growth do not seem to include any strong plans to acquire new customers or launch new products. Instead, international markets are seen as the most important driver of growth during the year ahead. Insurers currently view opportunities in overseas markets as more attractive than the market conditions prevailing in the UK.

## Life insurance

**Life insurers report stronger operating results for the second quarter running. Levels of new business are rising fast, albeit from a low base. The sector is looking to overseas markets for growth, while continuing to cut costs where it can.**

Life insurers' headline sentiment is holding steady. The sector's responses closely mirror those of the last survey, a pattern of stability that often seems to be a feature of life companies' responses. New business remains buoyant, demand is persistently strong and profitability is staying on an upward track. Building on the strong performance reported in March, these results seem to confirm that life insurers are emerging from a difficult period in their recent history. Throughout 2008 and 2009 the sector faced a combination of weak demand for its core products, falling investment values and tougher solvency requirements. The impression of recovery is reinforced by the upbeat trading announcements released by some insurance groups in recent months.

All the same, it is worth remembering that – in most cases – life insurers' sentiment is recovering from an extremely low level. Even though life companies have upbeat marketing plans, responses to forward-looking questions also suggest that levels of demand remain a concern. Despite the persuasive arguments for higher levels of long-term savings, new premiums in the domestic market are still feeling the effect of the economic downturn, together with other factors such as recent changes to the tax code. The looming prospect of the Retail Distribution Review also has the potential to put a brake on intermediary sales.<sup>9</sup> Instead of focusing on product innovation, life companies are therefore turning their attention to foreign fields. A balance statistic of +88% identify international markets as playing an important role in their growth plans for the year ahead.

This continuing sense of caution underpins some of the sector's other responses. A balance statistic of -83% say they have reduced total operating costs during the past quarter, and nearly as many intend to do so again. Similarly steep declines are also expected in numbers employed, staff costs and training expenditure. In contrast, a balance figure of +99% of respondents expect to spend more on regulatory compliance during the year ahead as the preparations for Solvency II begin to ramp up.<sup>10</sup>

8 See [www.pwc.co.uk/solvencyII](http://www.pwc.co.uk/solvencyII).

9 See [http://www.pwc.co.uk/eng/issues/the\\_retail\\_distribution\\_review.html](http://www.pwc.co.uk/eng/issues/the_retail_distribution_review.html).

10 See [www.pwc.co.uk/solvencyII](http://www.pwc.co.uk/solvencyII).

## Securities trading

**Securities traders report a steep fall in confidence at the time of the survey. Although market volatility has generated significant commission income, traders are uncertain where the European sovereign debt crisis will lead. Regulatory spending is rising fast, with profitability declining just as rapidly.**

Security traders' sentiment is falling, according to the strongest balance of respondents since the dark days of late 2008. Responses to the survey show that volumes of business and levels of income, which had been predicted to rally strongly, did not quite match up to the expectations reflected in the previous survey. Overall profitability also disappointed; more than half of respondents had forecast this would improve, but more than 70% now say it declined over the quarter. Critically, the survey was undertaken at a period of particular uncertainty in the financial markets. The Greek debt crisis might have begun during the first quarter of the year,<sup>11</sup> but continuing investor concern over the fiscal positions of Greece, Spain and a number of other European states<sup>12</sup> mean that security traders have had a particularly volatile few months.

Volatility is often good news for secondary market traders, since it generates high transaction volumes and, consequently, higher commissions. A small balance of respondents do report higher levels of commission income, but equivocal responses about customer demand suggest there is real uncertainty over how the European sovereign debt crisis will develop and what its knock-on impact might be. Although trading activity could benefit from volatility, many respondents are also active in corporate finance, IPOs and other forms of issuance. Volatile markets can cause a drag effect on transaction flow, and the much anticipated logjam of corporate activity is yet to materialise.

Despite their declining confidence, securities traders continue to report growing levels of headcount. This is seen as having pushed up remuneration expense ratios, but appears to contradict the sector's commitment to cost reduction. One area where costs are clearly on the rise is regulatory compliance. A balance statistic of +71% expect to spend more on this area during the coming year than they did during the past 12 months.

## Investment management

**Investment managers have had a good quarter, but downbeat predictions for fee income suggest that this could change. Expense bases are growing again, driven by staffing levels and the costs of compliance. Demand from foreign investors could provide a ray of light, however.**

Investment managers report little real change in sentiment, suggesting that their recent run of growing optimism could be levelling off. The sector appears to have enjoyed a successful quarter, with fee income seen as having increased and a balance statistic of +85% reporting strong levels of profitability. This is particularly impressive considering that demand from private clients is reported to have declined, probably in reaction to financial market volatility.

Unfortunately, predictions for the coming months are not so positive, with fee income expected to fall. Given that volumes of business are predicted to increase, this implies greater downward pressure on management fees. In contrast, operating expenses are expected to remain on their current upward trajectory, driven chiefly by larger numbers of employees and higher staff costs. As firms continue to replace some of the staffing capacity cut during 2008 and 2009, demand for skilled staff is increasing and remuneration levels are creeping back up. The costs of regulation also keep climbing, as the sector invests to ensure compliance with current requirements while also considering its approach to UCITS IV<sup>13</sup> and the possible final shape of the AIFM Directive.<sup>14</sup> The twin expectations of lower fee income and higher operating costs mean, inevitably, that a strong majority of respondents expect profitability to fall.

Nonetheless, investment managers' responses to some forward-looking questions are more positive. It is encouraging to see that the sector has a positive view of demand from overseas customers, and that acquiring international customers is seen as the most likely source of growth for the coming quarter. It is also notable that few respondents seem to expect mergers or alliances to play a role in future growth. This could be interpreted as a sign that firms have renewed belief in their ability to prosper without needing to engage in M&A.

<sup>11</sup> 'Greece condemned for falsifying data', Financial Times, 12.01.10.

<sup>12</sup> 'Volatility persists amid ongoing Eurozone fears', Financial Times, 29.05.10.

<sup>13</sup> See [www.pwc.com/timeforchange](http://www.pwc.com/timeforchange).

<sup>14</sup> See [www.pwc.com/aifmdnews](http://www.pwc.com/aifmdnews).

## About this survey

This survey was carried out between 19th May and 2nd June. A total of 73 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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Copies of the full survey are available from the Confederation of British Industry, tel: 020 7395 8071, email: 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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