# Financial Services Survey

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

## No.82

March 2010

PRICEWATERHOUSECOOPERS

# Contents

# Executive summary

## The 82nd CBI/PricewaterhouseCoopers financial services survey shows a picture of slightly stronger sentiment and growing predictions for volumes of business. Predictions for stronger commercial demand and steadying levels of non-performing loans offer other signs of encouragement. However, regulation is seen as an increasing limitation on business and concerns about the UK's competitiveness continue to grow.

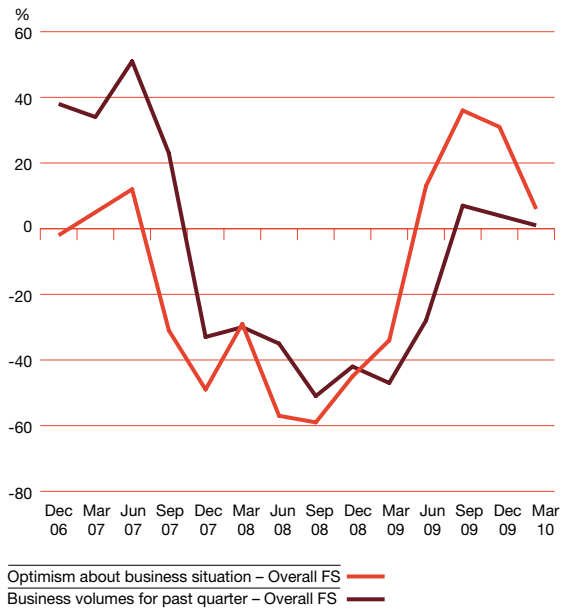
### Confidence improves slightly, and volumes of business are expected to accelerate

The current survey shows UK financial services sentiment improving slightly since the last survey, with overall volumes of business recording their third consecutive quarter of cautious growth (see Figure 1). This picture of growing stability is supported by most subsectors of financial services, the majority of which report relatively steady levels of confidence.

This mildly encouraging picture does not tell the full story. Respondents' predictions for business activity and customer demand are increasingly upbeat. An aggregated balance statistic of +48% expect volumes of business to increase during the next three months, the most positive such response since March 2006, with most subsectors following suit (see Figure 2).

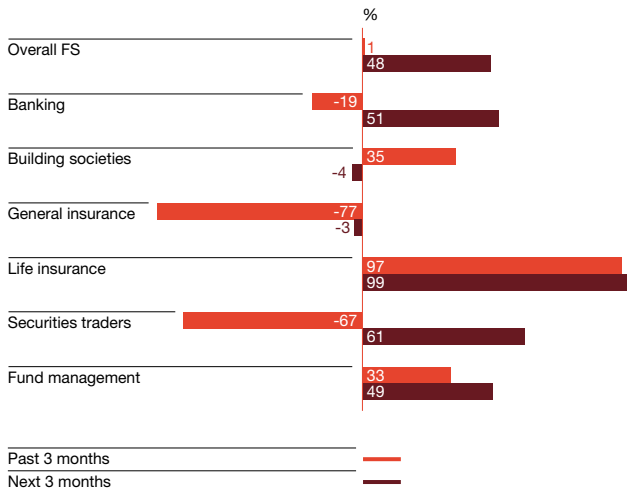
It is also notable that overall levels of activity with industrial and commercial customers are expected to climb by the strongest balance statistic in almost three years. However, hesitant demand from private individuals suggests that the slow recovery in the wider economy[1] will continue to overshadow demand for financial services.

Figure 1: Optimism and business volumes




Source: CBI/PricewaterhouseCoopers Financial Services survey, March 2010

Figure 2: Trends in volume of business




Source: CBI/PricewaterhouseCoopers Financial Services survey, March 2010

1 *'UK Economic Outlook'*, PricewaterhouseCoopers, March 2010

## Non-performing loans may have peaked; marketing plans continue to grow

Some of the more notable results to emerge from the current survey are lenders' predictions for non-performing loans. The banks now see the value of NPLs as stabilising, and building societies report NPLs as having fallen in the last quarter. Most subsectors continue to keep operating costs under tight control, leading to a third consecutive quarter of stronger aggregate profitability. Overall levels of headcount are expected to decline further, although this conceals wide variations between subsectors.

One area of spending which bucks the trend is marketing. Overall marketing plans are now reported to be growing by the strongest balance statistic since 2000. This represents a remarkable turnaround from just two quarters ago, although strong competition across financial services means that some of this spending is defensively motivated.

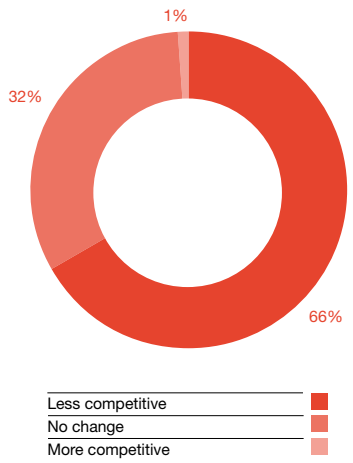
## The effects of regulation underpin increasing concern about UK competitiveness

Increasing regulation is a preoccupation for almost all respondents as the industry reacts to a variety of European and domestic initiatives. Increasing levels of regulation are also a factor behind the ever-strengthening view that UK financial services competitiveness is declining (see Figure 3).

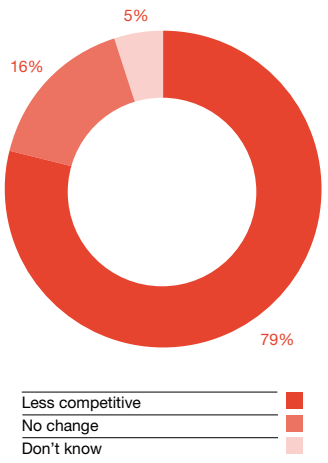
This response ties in with a recent study of global financial centre rankings,[2] and a general sense in the industry that increasing government involvement, while an inevitable result of the financial crisis, carries its own risks.[3]

Figure 3

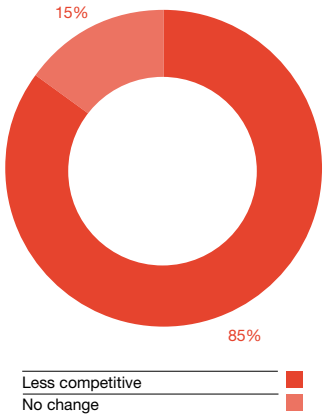
Impact of credit crunch on UK financial services competitiveness (Sep 09)




Impact of credit crunch on UK financial services competitiveness (Dec 09)




Impact of credit crunch on UK financial services competitiveness (Mar 10)




Source: CBI/PricewaterhouseCoopers Financial Services survey, September 2009-March 2010

2 *'New York ties with London for finance crown'*, Financial Times, 12.03.10
3 *'Banking Banana Skins 2010: After the quake'*, CSFI, February 2010

## Banking

**The banks' predictions for business activity are improving notably, although retail demand remains subdued. The value of non-performing loans is expected to stabilise and investment plans are increasing. The prospect of regulatory change remains a major source of uncertainty.**

After improving considerably during the second half of 2009, banking confidence remains steady. Most of the banks' responses strike a positive tone and predictions are the most upbeat for several quarters. For the first time in three years, more than half of respondents expect business volumes to increase. Interest and non-interest income are both seen as holding up well.

The banks' assessment of customer activity makes interesting reading. As predicted, commercial business was weak during the quarter, but activity in this segment is now expected to pick up for the first time since 2007. Demand from financial and overseas customers is also predicted to grow, lending weight to the impression that the banks expect economic recovery to continue. In contrast, predictions for retail activity are more equivocal, suggesting that growth in this area will remain hesitant.

The survey reveals a number of other positive indicators. Most notably, the banks appear to believe that non-performing loans are approaching an inflexion point, with the value of NPLs predicted to stabilise for the first time since the start of the financial crisis. Average spreads have widened for the sixth time in two years, as the banks continue to reprice maturing loans. Respondents also see the availability of funding as a decreasing concern. Profitability has remained steady, and the strongest balance statistic since 2006 predicts further improvement. Marketing intentions are experiencing a strong rebound, and the need for greater capacity is emerging as a significant driver of capital expenditure.

Of course, not every response is encouraging. Most notably, banks' levels of staffing are reported to have fallen, with further reductions predicted for the coming quarter. Regulation, unsurprisingly, remains the major source of strategic uncertainty for the sector.

## Building societies

**Building societies are enjoying a welcome uptick in activity, and report a decline in the value of non-performing loans. Even so, there is a lack of confidence about the sector's prospects. Increasing supervisory demands are driving a steep increase in regulatory spending.**

Building societies' sentiment remains relatively stable. This balanced response reflects the sector's perception of its situation. On the one hand, levels of business have increased, house purchase activity has picked up[4] and retail demand has improved. Respondents also see non-performing loans as having passed their peak, with a balance statistic of -29% reporting a decline in the value of NPLs.

On the other hand, it is unclear how sustainable the recovery in societies' activity will be, especially if interest rates rise, unemployment increases or house prices fall back. The uncertainty over the timing and possible effect of the withdrawal of monetary and fiscal stimuli to the broader economy is also a potential concern. The societies' overall business environment remains distinctly challenging. A small balance of respondents feels that average spreads are declining again, with the market for retail savings particularly competitive. The societies are also expecting to recommence their focus on headcount reductions as a means to keep costs in check.

The sector's future spending plans reveal a balanced view. On the positive side, marketing expenditure is expected to rise further, with societies hoping that recent declines in house price indices[5] will not develop into a trend. The societies expect brand and advertising to play an increasingly important role in their plans, and a strong majority are focusing on improving their market share. Less positively, spending on regulatory compliance is forecasted to grow by a balance statistic of +74%, up from just +28% in the last survey. The scrutiny from the Financial Services Authority (FSA) continues, and when the survey was conducted respondents would still have been anticipating the introduction of the new liquidity regime.

4 *'Buyers brave Britain's big freeze'*, National Association of Estate Agents (NAEA), 11.02.10
5 *House Price Index*, Lloyds Banking Group, 04.03.10; *'House prices slip in the winter snow'*, Nationwide, 26.02.10

# Life insurer's sentiment has barely moved since the last survey, but the sector reports a strong uptick in business activity and premium income.

## General insurance

**General insurers report a picture of falling confidence, reflecting a perception that the operating environment in the current year is unlikely to be as favourable as during 2009. Spending on regulatory matters is expected to grow.**

General insurers' confidence has declined slightly, ending a run of increasing optimism that began in 2008. As predicted, activity declined during the first months of the year, with more than three quarters of respondents reporting falling levels of business, premiums and investment income. Demand from personal and commercial customers is falling at the fastest rate seen for several years.

These responses may look odd, given the strong results recently announced by a number of UK insurers. However, they are indicative of a general feeling in the sector that trading conditions, so favourable in 2009, are unlikely to be as advantageous in the current year. First, many insurers feel that achieved pricing for current new business is too low, but are struggling to secure rate increases in a very competitive environment. Second, customer retention levels are falling, with most insurers facing increasing levels of churn. Third, investment returns are unlikely to take up as much slack as during 2009. And fourth, claims are expected to increase by a balance statistic of +90%.

Insurers report a decline in profitability. A number of firms were able to release an element of prior year claims reserves during 2009, but this is a trend that is unlikely to continue. The sector is responding by keeping operating expenses under tight control. Even so, the costs of regulation are growing fast. After reporting surprisingly low levels of regulatory spending in the last survey, a balance statistic of +89% now expects to spend more on compliance in the coming year. Solvency II is the major driver,[6] although the approach of IFRS Phase II accounting may also be a factor.[7]

## Life insurance

**Life insurers report a welcome increase in activity, with strong reported growth in new business and profitability. Even so, the sector retains a sense of caution, and with the exception of marketing and compliance, spending plans are being held in check.**

Life insurers' sentiment has barely moved since the last survey, but the sector reports a strong uptick in business activity and premium income. Responses about new business are as high as they have ever been, and a balance statistic of +99% expect further improvements in the coming quarter. In another positive turnaround, overall profitability is reported to be on an upward track by almost all respondents.

These responses are consistent with recent announcements by several life companies, highlighting a pick-up in activity during the final months of 2009. It remains to be seen whether this recovery in business will be sustained. True, house prices and house purchase activity have strengthened since the summer of 2009, investment markets have stabilised and the economy is moving slowly out of recession.[8] However, demand for property and investment products is still far weaker than life insurers would wish, and the sector is not throwing caution to the winds yet. Revenues may have grown but operating expenses remain under tight control, and headcount is reported to be on a downward trend.

Two major areas of spending are resisting cutbacks. The first is marketing, where investment intentions remain high. The second is regulatory spending, which remains stubbornly buoyant. Solvency II is now a reality and will be a significant driver of spending in the coming year.[9] The sector shows an increasing interest in new products, as life companies begin to consider their response to the Retail Distribution Review. Interest in international markets and the use of strategic partnerships is increasing, as the sector considers expanding its footprint outside domestic markets.

6 *'Countdown to Solvency II: Bridging risk and capital: Edition 5'*, PricewaterhouseCoopers, June 2009
7 *'Making sense of the numbers'*, PricewaterhouseCoopers, November 2009
8 *'UK Economic Outlook'*, PricewaterhouseCoopers, March 2010
9 *'Countdown to Solvency II: Bridging risk and capital: Edition 5'*, PricewaterhouseCoopers, June 2009

## Securities trading

**Securities traders report a downturn in volumes of business and profitability, reflecting the end of 2009's equity market rally. Performance is predicted to improve again during the coming quarter, but the sector retains a degree of caution about its outlook.**

Confidence among securities traders is declining for the first time in a year. After three successive quarters of growth, traders report a downturn in volumes of business and levels of commission income. Profitability is also seen as having fallen by two thirds of respondents. In contrast, a solid majority now predict that business volumes, commission income and levels of profitability will pick up again, suggesting that the last quarter's weak performance was a one-off, not the start of a trend.

Securities traders' assessments of customer activity provide a clue to this apparent reversal. Business with financial institutions is reported to have declined by a balance statistic of -67%, but is predicted to increase again by a balance figure of +74%. This suggests that the fluctuations in equity markets during the first quarter of the year could explain the sector's shifting fortunes. The FTSE 100 Index lost 8% of its value during the first five weeks of 2010,[10] as investors took profits from the market recovery of 2009. However, by the time the survey was conducted the market had started to rally, and concerns about the possibility of a double-dip recession had begun to ease.[11] These factors may also account for the strong upswing in hiring reported during the quarter.

The sector's short-term forecasts may be confident, but traders are less certain about their medium-term outlook. Levels of demand, competitive pressures and the impact of legislation and regulation are all seen as potential concerns. The sector's motivations for capital expenditure are revealing, with respondents citing a range of drivers for investment, including greater efficiency, developing new products and meeting compliance requirements. As we pointed out in December, it is also worth remembering that the market retains the potential to generate financial shocks, such as the Greek debt crisis.[12]

## Investment management

**Investment managers remain upbeat and are now the most positive of the industry's sub-sectors, reporting strong operating results. Demand from private individuals did not meet expectations, however. Recruitment plans are increasing again, driven in part by growing regulatory demands.**

Investment managers remain in positive mood, reporting the strongest sentiment of any sub-sector. The sector has enjoyed a third consecutive quarter of growing business volumes and commission income. The strong operating leverage which is a feature of investment management means that profitability is seen as having increased by a majority of respondents.

In contrast to this encouraging picture, it is notable that retail activity is reported to have remained steady during the quarter. Nor do respondents expect retail demand to pick up, a surprising result given the approaching end of the tax year. This picture is given some support by published Investment Management Association (IMA) data,[13] which shows January to have been the weakest month for net retail sales since the equity rally began in March 2009. Fortunately, activity with other customer segments is reported to be holding up. In particular, a majority of respondents are hoping to do more business with overseas customers.

Despite their short-term confidence, investment managers remain concerned about future levels of demand, suggesting that confidence in the recovery could yet prove to be fragile. Respondents seem to be showing less interest in developing new products than before, prompting the question of whether the sector has yet developed a clear strategy for long-term growth.

With revenues growing, investment managers are allowing operating expenses to rise too. A balance statistic of +94% also now expect to employ more staff during the next three months. This reflects a range of factors, including the approach of UCITS IV, the growing attention being paid to risk management by managers and investors, and the increasing strain that regulation is putting on back and middle offices. Regulation is also identified as a key driver of capital expenditure. The slowly emerging shape of Alternative Investment Fund Managers Directive (AIFMD) may be a factor,[14] but of more immediate concern is increasing focus on client money and client asset regulations by investors and the FSA alike. Many firms are spending time and effort to ensure they are fully compliant.

## About this survey

This survey was carried out between the 17th February and 3rd March. A total of 80 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).

10 Markets Data, FT.com, 12.03.10
11 *'Forecast for the UK economy: A comparison of independent forecasts'*, HM Treasury, 20.01.10 and 17.02.10
12 *'Greece condemned for falsifying data'*, Financial Times, 12.01.10
13 *'Investment Fund statistics, January 2010'*, Investment Management Association, 08.03.10
14 *'AIFMD News: A Directive in flux – the confusion persists: Edition 2'*, PricewaterhouseCoopers, January 2010

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Copies of the full survey are available from the Confereration 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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