

Financial Services

# Financial Services Survey

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

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## Contents

- 02 Executive summary
- 04 Banking
- 04 Building societies
- 05 General insurance
- 05 Life insurance
- 06 Securities trading
- 06 Investment management
- 07 About this survey
- 08 Contacts

## Executive summary

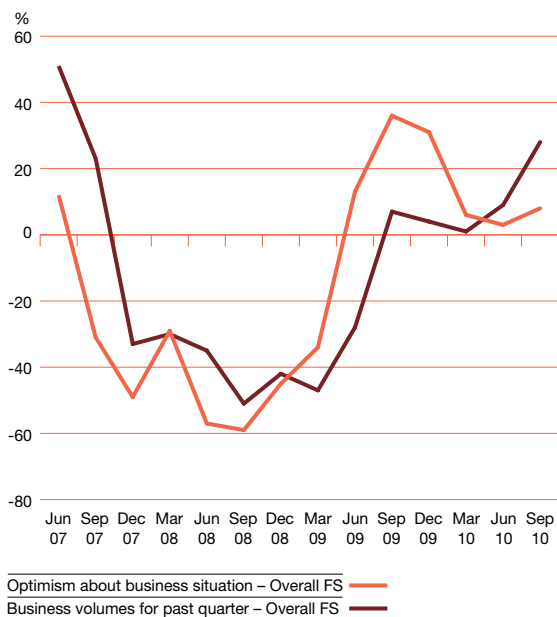
The 84th CBI/PricewaterhouseCoopers Financial Services Survey shows industry confidence continuing its recent pattern of cautious growth, while volumes of business have accelerated across most sub-sectors of the industry. Careful cost management and increasing profitability are other welcome features of the results. Even so, respondents remain cautious about the outlook for business, and regulation is a pressing concern for many in the industry.

### Confidence increases slowly, but volumes of business are accelerating

The survey shows the sixth consecutive improvement in UK financial services sentiment. The largest balance of respondents since 2007 also report higher aggregate volumes of business (see Figure 1). This is very much in line with June's predictions of stronger activity, and a clear improvement on the hesitant growth seen in recent quarters.

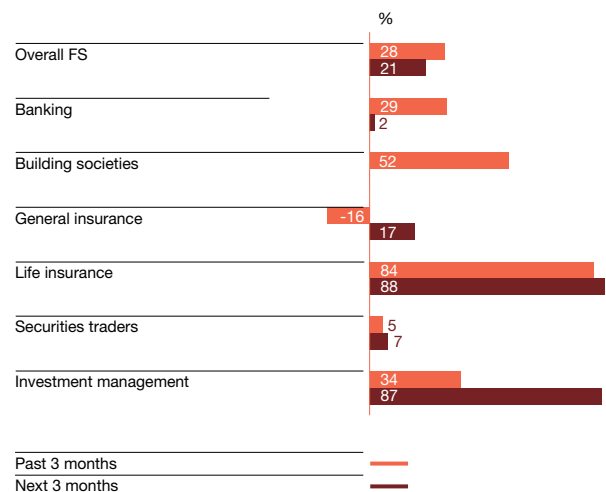
With the exception of general insurance, the increase in volumes of business is reported across all the major sub-sectors of financial services (see Figure 2). Overall levels of business with both commercial and retail customers are seen as having improved, an encouraging sign for the nascent UK economic recovery. A double dip does not currently feature in most economists' main scenarios, but consensus forecasts suggest that the UK will enjoy modest growth this year, with consumer spending expected to lag behind the broader economy.<sup>1</sup>

Figure 1: Optimism and business volumes



Source: CBI/PricewaterhouseCoopers Financial Services Survey, September 2010

Figure 2: Trends in volume of business



Source: CBI/PricewaterhouseCoopers Financial Services Survey, September 2010

Despite these improvements, it is worth noting that all major sub-sectors are now taking a more measured view of their growth prospects, with the banks and building societies particularly cautious about the outlook for the coming quarter.

### Note on methodology

The CBI Survey Management Group has recently converted its entire suite of business surveys to new UK and European technical requirements. This quarter's data set is the first to be reported under the revised classifications and weightings. For more details, please refer to 'About this survey' on page 7.

### Cost control and cautious hiring are giving a boost to profitability

Overall, the industry is maintaining its strong focus on operational costs, although – buoyed by their top-line performance – investment managers are allowing costs to rise. As predicted, aggregate numbers employed grew during the quarter, with general insurers and investment managers taking the lead in terms of hiring. However this is now expected to reverse, suggesting the uptick was a one-off improvement rather than the start of a trend.

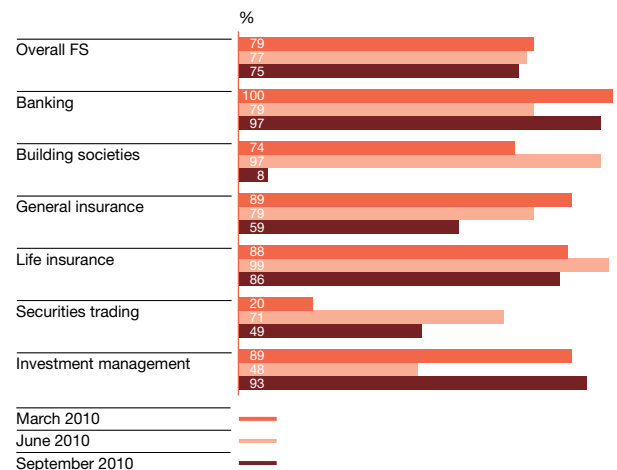
The overall value of non-performing loans is reported to have remained steady, a disappointing response when compared to lenders' upbeat predictions for the quarter. Nonetheless, banking respondents still anticipate an improvement in this area. Overall profitability is reported to have grown by the largest balance statistic since June 2006, with all major sub-sectors except for the banks enjoying improved returns.

### Persistent concerns over demand and regulation are a feature of the industry's outlook

Looking further ahead, respondents are most concerned about levels of demand. This reflects a range of factors, including caution over the economic recovery and a lack of clarity about the potential impact of fiscal tightening.

Regulation also remains an issue of serious concern to the industry, which faces an exceptional range of new initiatives emanating from UK, European, US and global bodies. Regulation is a significant driver of investment, second only to efficiency gains, and all major sub-sectors of financial services expect to spend more on compliance during the year ahead. In the case of banking, life insurance and investment management – which face some of the most onerous requirements – almost all respondents expect regulatory spending to expand over the next 12 months (see Figure 3).

Figure 3: Regulatory compliance: Spending expectations for the next 12 months



Source: CBI/PricewaterhouseCoopers Financial Services Survey, September 2010

## Commercial business is reported to have grown by the strongest balance statistic since 2008, but activity with retail customers disappointed.

### Banking

**Banking activity has not lived up to the high expectations of the previous survey, and the sector remains concerned about demand, competition and regulation. However, costs and non-performing loans are under control and profitability is expected to rise in the coming quarter. This suggests that banks are themselves in good shape, with business constrained by the economic environment.**

Despite the confident predictions of the last survey, banking sentiment remains steady for the third consecutive quarter. Volumes of business may have increased, but they do not seem to have lived up to June's high expectations. Meanwhile revenue streams – also predicted to rise – are seen as having stagnated. Commercial business is reported to have grown by the strongest balance statistic since 2008, but activity with retail customers disappointed. Overall, the survey responses suggest that the banks have not climbed quite as far up the recovery curve as had been hoped.

The banks seem well placed to profit from the gradual recovery in business. Average spreads are reported to have expanded once again, as loans roll over and the banks reprice their risks. Non-performing loans may not have achieved the hoped-for reduction in value, but respondents remain confident they will decline during the coming quarter. The anticipated growth in headcount has been reversed, with numbers employed reported to have fallen. This contributed to the banks' tight control on operating costs, helping the sector to report a quarter of steady profitability and an expectation of further improvement.

Look further forward, however, and the impression of uncertainty returns. Concern about levels of demand is strengthening again, and is identified as a limitation on business by 99% of respondents. In response, the banks are focusing on cross-selling as a source of growth. Plans to develop new products and spend more on advertising, marketing and distribution suggest that there is optimism about the medium term and that renewed competition may be in the offing. In this context, it is notable that new entrants are seen as less of a threat than before, implying that the banks expect a shake-up of existing market shares rather than the arrival of entirely new competitors. Regulation emerges as the banks' second greatest concern, with almost all those surveyed expecting to spend more on compliance during the year ahead. The survey was conducted prior to the Basel III agreements, and the impact of additional capital requirements has not yet been felt.

### Building societies

**Building societies report improvements in volumes and profitability, albeit from a low base. The sector's outlook remains uncertain, with funding a particular challenge. Revenues are expected to decline again in the coming quarter.**

Building societies' sentiment remains steady, which could be interpreted as an encouraging response given the range of competitive and regulatory forces pressurising the sector. On the positive side, a balance statistic of +52% report increased volumes of business, and activity in the all-important retail segment is seen as having grown. Net interest income and average spreads have also increased, reflecting modest margin expansion as existing mortgages are repriced or redeemed and new loans advanced at more economic rates.

Unfortunately, not all the survey responses are so positive. Overall forecasts for levels of business and the value of income are to the downside, and net interest income is predicted to fall again. It is slightly surprising that so many respondents still see business as being 'below normal', as this implies a permanent recovery in activity from current levels. As we have suggested before, the sector might need to reconsider how realistic its expectations are. For example, while average house prices have recovered ground since early 2009, recent months have seen fresh signs of cooling.<sup>2</sup> With this in mind, it is notable that non-performing loans are reported to have grown during the quarter, despite the confident predictions of the last survey.

Funding is still the societies' largest challenge. The sector is becoming less reliant on wholesale finance, but it is struggling with the limited availability and high cost of retail deposits. Societies find themselves in strong competition with the banks and, to a lesser extent, National Savings & Investments. As a result, respondents are focusing on customer retention on both sides of the balance sheet, supported by planned investments in distribution and marketing. The societies are trimming headcount and keeping operating costs on a downward trend, although wholesale staff reductions remain rare. A strong balance of respondents report increased profitability, but this reflects a relative improvement, not an absolute one.

<sup>2</sup> 'House prices see second consecutive monthly fall in August', Nationwide, 02.09.10

## General insurance

**General insurers' business situation remains stable, although premium rates are under pressure in commercial lines. Profitability has improved, but investment income is expected to decline and the value of claims is forecast to grow.**

Confidence among general insurers has steadied after the last quarter's surprising jump, mirroring the stability of the non-life market over the past few months. The sector reports further pressure on premium income, reflecting the intense competition which has been a feature of the market in recent quarters. Premium rates remain fairly static, but while some firms have managed to push up rates in the retail arena, commercial lines continue to see pricing soften. Many in the industry feel that this picture is unlikely to change in the short to medium-term, barring a major loss event.

This view is supported by respondents' assessment of the year ahead, which identifies competition – particularly within the sector – as its greatest concern. Plans for growth have consequently shifted away from the international business that was a feature of June's survey. Instead the focus is on acquiring domestic customers, with marketing plans increasing for the third quarter running.

General insurers' investment income is still seen as declining and, as anticipated, the value of claims has increased for a second time this year. Considering the pressure on premium rates, it is therefore surprising that profitability is reported to have improved, albeit by a small balance of respondents. In addition to the impact of operating cost reductions, this may have received a boost from the release of prior year reserves. After several quarters of headcount reductions, insurers report a surprising uptick in staffing levels. Regulatory spending continues to climb, as insurers focus on the fifth Solvency II Quantitative Impact Study.<sup>3</sup> The publication of the IFRS Phase II Exposure Draft is also focusing minds on accounting, with companies preparing impact analyses and considering their responses to the proposals.

## Life insurance

**Life insurers continue to report a recovery in activity, and profitability is seen as being on an upward track. However, the maturity of the UK market and the potential fragility of demand both appear to be on the minds of respondents.**

Life insurers report their strongest increase in confidence for over a year. This is the third consecutive quarter of renewed positive performance reported by the survey, and the improvement in activity appears to be lifting the sector's overall sentiment. These results suggest that, after a couple of difficult years, the life industry is increasingly confident that it is moving forward. Almost all respondents see activity and new business as being on an upward trend, and business is growing across all customer segments, particularly private individuals. With operating costs remaining under tight control, it is not surprising that a strong balance of respondents report increasing profitability and expect to see more of the same during the coming quarter.

Even so, it is worth noting that all respondents remain concerned about levels of demand, and see uncertainty over business prospects as the most likely limitation on their investment plans. This is a reminder that demand for life companies' core products remains potentially vulnerable to financial market volatility or housing market weakness. Marketing intentions are expanding as the sector looks to stimulate business, with sales and distribution identified as particular areas of focus. More broadly, concerns over demand reflect the maturity of the UK life insurance market. The life industry has seen an increase in M&A activity in recent months as European groups look to restructure their businesses to refocus on higher growth and emerging market opportunities.<sup>4</sup> This probably explains respondents' increasing interest in M&A as a potential source of growth.

Apart from growth, the sector's other major preoccupation is regulation. As with the general insurers, Solvency II<sup>5</sup> and IFRS Phase II accounting are the primary drivers of spending, but looking further ahead, the potential impact of the Retail Distribution Review on patterns of distribution is also a source of concern.

<sup>3</sup> See [www.pwc.co.uk/solvencyII](http://www.pwc.co.uk/solvencyII)

<sup>4</sup> 'European FS M&A Insight', PricewaterhouseCoopers, September 2010

<sup>5</sup> See [www.pwc.co.uk/solvencyII](http://www.pwc.co.uk/solvencyII)

## Securities trading

**Securities traders' sentiment is still falling, though not as quickly as before. Profitability has improved, but this is expected to reverse in the coming quarter. The sector remains unsure about its outlook, and regulatory spending continues to climb.**

After a steep fall in confidence in the last quarter, securities traders report a less emphatic decline in sentiment. However, the strong uptick in volumes of business and levels of commissions reported in June has not continued – the third time in a year that trading income has failed to live up to respondents' expectations. On this occasion, a fall in market volatility from the levels seen in the early summer may have contributed. Business with private individuals is seen as having improved, perhaps reflecting the attraction of security yields – particularly in relation to equities – at a time when the interest rates paid by deposit takers are at historically low levels. However, expectations of demand from all customer segments in the coming quarter are modest at best.

In response, securities traders report much stronger interest in launching new products as a route to growth. Although it is not clear from the questionnaire what this might involve, this matches our impression that securities houses are seeking to develop products and services that will help to answer more sophisticated client demands, often prompted by the need to meet new regulatory pressures.

Profitability is reported to have strengthened for the first time this year, supported by further reductions in operating costs and slower reported growth in headcount, but this improvement is not expected to last. Regulatory spending continues to climb, reflecting a general expectation that new compliance requirements will have a negative effect on expense levels. Uncertainty over regulation has affected confidence, but the announcement of Basel reforms will dispel some of those concerns and securities houses can now begin to plan a response. Looking further forward, wariness about the state of the UK and European economies continues to weigh on strategic planning. Uncertainty over business prospects is seen as a limitation on capital expenditure by 93% of respondents, and levels of demand are seen as the factor most likely to limit business growth during the coming year.

## Investment management

**Investment managers continue their recent run of confidence, buoyed by the relative stability of equity markets in recent months. Costs are being allowed to rise, illustrated by the sector's hiring plans. Investment managers are preparing to implement a raft of regulatory initiatives.**

Investment managers report a further improvement in confidence, the sixth in a line that began with the recovery in equity markets during the spring of 2009. Volumes of business and levels of fee income grew during the quarter, and strong balances of respondents expect further improvements. Business with financial, personal and overseas investors is reported to have expanded, and is expected to continue growing into the autumn. International business in particular seems to be a source of optimism, generating the strongest business volumes of any customer segment.

These are very encouraging responses, and consistent with firms' anecdotal comments about their performance. Apart from a few days in May and July, the FTSE 100 Index has stayed above 5,000 points for the first eight and a half months of the year.<sup>6</sup> Many firms based their projections for the year on an average of around 5,000 points, so current market levels are pushing revenues over budget and allowing firms to grow their operating expenses.

This tendency is clearly illustrated by numbers employed, which are reported to be growing by the large majority of respondents. Firms are still cautious about adding staff too quickly, but they are also conscious of the difficulty of recruiting skilled staff in areas such as risk management, finance and compliance. With a wave of new regulation approaching fast,<sup>7</sup> investment managers do not want to find themselves trying to attract skilled joiners at short notice. In the UK, the FSA is setting out new client money rules and testing existing requirements more stringently, and its consultation paper on updating the Remuneration Code is focusing attention on staff reward. At the European level UCITS IV is approaching fast and the final shape of the AIFM directive will soon emerge; and emanating from the US, FATCA and Dodd-Frank will have an impact on many UK-based investment managers.

6 FT.com/marketsdata, 10.09.10

7 'Asset Management News', PricewaterhouseCoopers, September 2010 – <http://www.pwc.com/amnews>

## About this survey

This survey was carried out between 18 August and 1 September. A total of 90 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)).

The CBI has recently updated the way that sectors are classified and reported across its suite of business surveys. Sector classifications are now in line with the latest official UK Standard Industrial Classification (SIC 2007), which meets the CBI's data supply requirements for the European Commission. New SIC 2007 classifications for the financial services industry have only slightly altered the underlying coverage of the CBI/PwC Financial Services Survey, allowing the existing main sector groupings within the survey to be retained.

New survey weights are derived from data provided by the Office for National Statistics, part of which has been sourced from the Bank of England, the Association of British Insurers and data from financial markets. These new survey weights reflect the shifts in financial services activity that have occurred over time, for example, banking now represents a greater share of overall financial services than previously (see page 35 of the CBI/PwC Financial Services Survey publication for the list of new survey weights).

From September 2010 onwards, the CBI will be publishing the reclassified and re-weighted Financial Services Survey data spliced onto existing historical data, in keeping with the convention recently adopted across all the other CBI business surveys. The trends in the Financial Services Survey data under the new and old methodologies are very similar over time.

## Contacts

To discuss the implications for the various sectors, please speak to your usual PricewaterhouseCoopers contact or one of the following:

### Financial services

#### Chris Jones

UK Financial Services Leader  
020 7804 2393  
chris.p.jones@uk.pwc.com

### Banking

#### Andrew Gray

020 7804 3431  
agray@uk.pwc.com

### Building societies

#### Mark Hannam

0113 289 4307  
mark.a.hannam@uk.pwc.com

### Capital markets

#### James Worsnip

020 7804 9635  
james.c.worsnip@uk.pwc.com

### Investment management

#### Pars Purewal

020 7212 4738  
pars.s.purewal@uk.pwc.com

### Rob Mellor

020 7804 1385  
robert.mellor@uk.pwc.com

### Insurance

#### Andrew Kail

020 7212 5193  
andrew.kail@uk.pwc.com

### Gavin Phillips

020 7804 9988  
gavin.phillips@uk.pwc.com

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.

This bulletin is produced periodically to address important issues affecting the financial services industry. If any of your colleagues would like to be added to the mailing list or if you do not wish to receive further editions, please write to:

Max Harmer  
PricewaterhouseCoopers LLP  
6 Hay's Lane  
London SE1 2HB  
or send an email to: max.j.harmer@uk.pwc.com

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