

Financial services survey

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

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Executive summary

The 79th CBI/PricewaterhouseCoopers financial services survey shows the industry feeling more confident for the first time in two years. This could mean that the worst is past, but it does not yet herald a recovery. Hopes of stabilisation are tempered with caution about the length and severity of the economic downturn, and firms continue to focus on cost control.

An improvement in sentiment could signal that the industry has hit bottom

The survey shows a notable shift in financial services sentiment, which has improved for the first time in two years (see Figure 1). Clearly, this is welcome news for the industry. However a quarterly improvement does not necessarily signal a recovery, or a return to pre-crisis confidence levels. Rather, it suggests that the industry's

decline in business could be about to bottom out.

This interpretation is supported by the responses of the key sub-sectors of financial services (see Figure 2). Most report feeling more positive – or at least less negative – than in March, but in many cases this reflects hoped for, not actual, improvements in business activity. In aggregate, volumes of business and levels of income are reported to have declined during the quarter, although there is

Figure 1: Optimism and Business Volumes

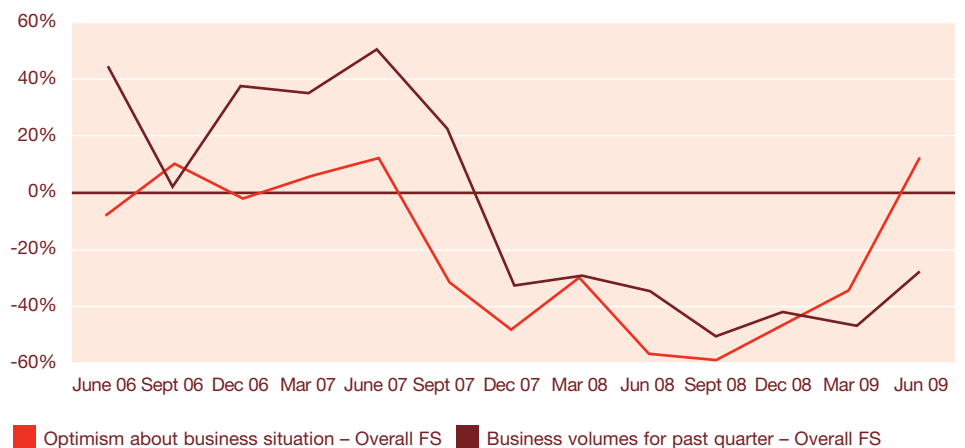
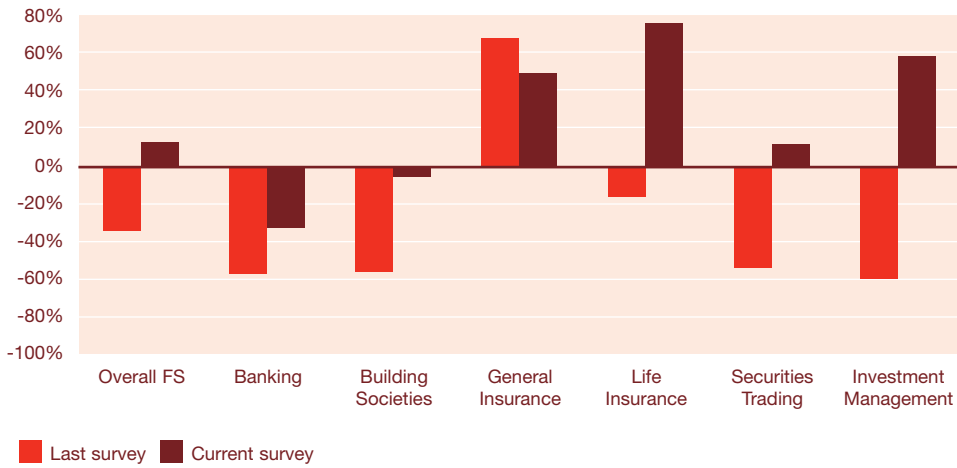


Figure 2: Optimism about overall business situation – Key sectors



some cautious hope that volumes may begin to recover over the summer.

Recovery remains some way off and long term competitiveness is a growing concern

Respondents' views on the broader financial crisis underpin the more balanced predictions they make for their own sectors. Only 5% of those surveyed expect financial market conditions to improve before 2010, but just 1% feel there is a high chance of further deterioration compared with 45% in March. This reflects a growing view that while the worst phase of economic contraction may be over, recovery in output and employment will be slow. For example, one bank that predicted a 2010 UK unemployment rate of 7% in October 2008 has now revised its forecast to 10%¹.

The concept of an 'L-shaped' recovery is also one of the factors driving respondents' forecasts of

higher impairment charges and insurance claims. Of longer-term concern is the fact that UK industry competitiveness is seen as having weakened slightly since the last survey (see Figure 3a and 3b).

Firms continue to focus on managing through the downturn

Against this backdrop, it is hardly surprising that the survey shows aggregate falls in profitability across the industry. Respondents continue to focus on cost cutting and the outlook for employment remains negative, albeit slightly less so than at the last quarter. Customer acquisition costs are under review, with most respondents favouring defensive marketing strategies and a focus on customer retention. Several sub-sectors also report growing concern about the possible effects of regulation, as authorities in the UK and Europe weigh their responses to the financial crisis.

Figure 3a: Impact of Credit Crunch on UK Financial Services Competitiveness (March 09)

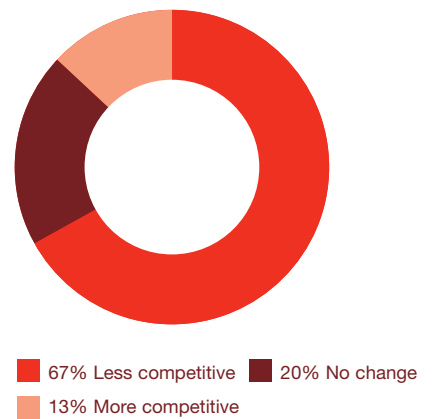
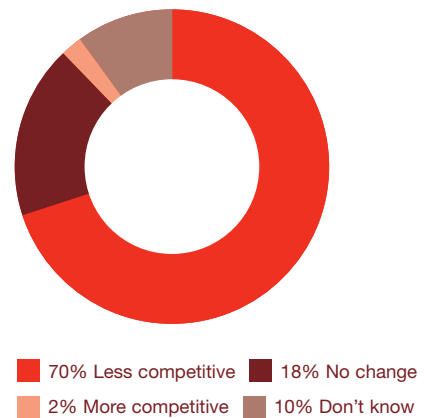


Figure 3b: Impact of Credit Crunch on UK Financial Services Competitiveness (June 09)



¹ 'Economic Review', HSBC Bank plc – Issues 50 and 52, 30.10.08 and 02.04.09.

Any potential improvement in customer demand is also clouded by the probable impact of the recession on impairment charges. A balance statistic of +97% report higher non-performing loans and the trend is expected to continue.

Banking

Banking sentiment is less negative than in recent quarters. Some respondents are predicting an increase in business over the summer months, but concern about impairments is clouding the picture. The potential impact of new regulation is a preoccupation for many.

Banking sentiment remains in negative territory, but respondents at least feel less pessimistic than in recent quarters. The last survey's hoped-for recovery in business has not materialised, but a balance statistic of +36% now predict activity will increase in the coming months, the strongest such response since early 2007. A modest number of the banks report an increase in retail business during the past quarter, a response that chimes with evidence of increasing activity in the housing market².

Even so, the banks are hardly getting carried away. A large number of respondents remain sceptical about growth prospects, and business plans for the year ahead are largely defensive. The sector is concentrating on existing customers and on getting the most out of branches, its core distribution channel. Spending plans also suggest that a sustained upturn is not yet on the cards. Staff numbers continue to fall, albeit with less momentum than before, and marketing spending is still on a downward track. The few banks that are investing in infrastructure are

largely focusing on efficiency. There is also palpable concern about the potential impact of a tougher regulatory environment.

Any potential improvement in customer demand is also clouded by the probable impact of the recession on impairment charges. A balance statistic of +97% report higher non-performing loans (NPLs) and the trend is expected to continue. It is also notable that corporate NPLs are now reported to be growing as rapidly as those in retail. The stabilisation of base rates has allowed the banks to widen their average spreads again, but weak demand for credit means that the overall outlook for profitability remains negative.

Building societies

Building societies have recovered some of their poise, and are hoping that business may soon stabilise. Even so the sector remains under considerable pressure, with arrears climbing and net interest margins being squeezed from both sides of the balance sheet.

After several very downbeat quarters, building societies now feel relatively neutral about their business situation. This surprising response reflects the hope that volumes of business and levels of revenue, in near-freefall, will stabilise soon. As yet however, there is no sign of a recovery in activity.

As a sector, the societies remain in a very tight spot. Pricing pressure continues to bite. Many societies are

² 'Property sales reach 18 month high', National Association of Estate Agents, 18.05.09.

de-risking their asset books but new business is too sparse to offset the resulting dilution in average margins. On the liability side of the balance sheet the need to retain long-term savings deposits in a very low interest rate environment is depressing margins. A balance statistic of -97% see average spreads as having fallen during the past quarter, and while this is now predicted to stabilise only a brave soul would rule out the possibility of renewed pressure. NPLs are also a major concern. Arrears are growing across the UK mortgage market³ and almost all respondents expect current deterioration to continue.

In a more positive vein, the survey suggests that the societies are at least trying to adapt to the changed world in which they find themselves. Almost all are aiming to sell new products to their existing customers and plan to invest in customer relationship management. Even so, the recent downgrading by Moody's of nine prominent building societies⁴ is a reminder that the sector remains exposed to negative shocks. One such example is the potential requirement to make capital repayments to the Financial Services Compensation Scheme⁵.

The societies continue to cut costs, and the sector retains an uncharacteristically negative view of the prospects for headcount. This does not just reflect the societies' tight operating margins, but also a general atmosphere of uncertainty over the strength of future demand.

General insurance

General insurers continue to feel positive, but their optimism about premium rates is tempered with a degree of caution. Last quarter's recruitment plans have been reversed and the cost of claims is expected to increase.

General insurers continue to feel more positive about their outlook, even if they are not quite as bullish as at the last survey. In particular, volumes of business and the value of premiums did not live up to last quarter's confident forecasts. Where a balance statistic of +60% had predicted premium growth, a figure of -10% now report that premiums fell during the quarter. Nonetheless, positive balance statistics predict stronger premium income for the coming months. This more tentative optimism reflects the fact that whilst some insurers are reporting rising premium rates they are not hardening as fast had been hoped, and others are not seeing any increase in rates.

Insurers' other survey responses also suggest a combination of confidence and caution. On the upside, the sector is less concerned about the threat of weak demand than many of its financial services counterparts. Insurers are also relatively confident about their ability to generate new business and are less concerned with customer retention than most.

On the downside however, cost cutting plans continue to advance and a modest balance of

respondents say that marketing spend is falling. Most notably, insurers' previous recruitment plans have been reversed, bringing the sector into line with other areas of financial services. General insurers' modest spending on regulatory compliance is also a surprise, given the requirements of Solvency II. Despite these cost reduction measures, some insurers now expect profitability to fall. The cost of claims is a factor here, with a majority of respondents expecting claims to increase as the recession bites.

Life insurance

Life insurers report an upswing in sentiment. There are hopes of a recovery, but business remains subdued for now. Expense reduction and customer retention are still the order of the day.

Life insurers report a strong upswing in their headline level of confidence. A balance statistic of +75% are feeling more optimistic, making this the sector's most positive response for five years. At face value this is an unexpected result, given the still-subdued demand for investment and protection products. And in fact, all those answering the survey report that business volumes and the value of new business have declined during the past three months. So what explains the sudden change of heart?

3 'Arrears and possessions', Council of Mortgage Lenders, 15.05.09.

4 'Moody's downgrades building societies', Financial Times, 15.04.09.

5 'Building societies face challenging year', Financial Times, 17.05.09.

Securities traders are feeling slightly more optimistic about their business situation, the first such positive response in two years.

The answer seems to lie in the life companies' predictions for the coming quarter. Balance statistics of +43% expect business volumes and profitability to strengthen over the next three months, the most positive such responses since 2007. Possible reasons for this new-found optimism include the modest increase in average house prices seen in recent months⁶ and the rally in equity markets – the FTSE 100 index climbed 24.8% during the three months to the start of June⁷. If justified, these expectations could mark the end of a long downturn in business for the life industry. Before getting too excited however, it is worth remembering that the survey measures confidence on a quarter-on-quarter basis. The current improvement follows no fewer than seven consecutive quarters of increasingly negative sentiment.

There is nothing in the survey results to suggest an upturn in business has yet materialised. All respondents remain worried about the potential impact of weak demand on their business prospects, and like many other sectors the life companies are focusing on customer relationship management and retention. The sector's expenditure plans also suggest a degree of caution. Almost all those surveyed are cutting costs, headcount is being actively managed downwards and marketing expenditure plans are being universally cut. One area of mandatory spending is compliance. After several quarters when life

companies reported surprisingly low levels of regulatory spending, a large majority now expect to spend more as they work towards the requirements of Solvency II.

Securities trading

Securities traders are enjoying a welcome improvement in sentiment, reflecting more buoyant equity markets. Even so, forecasts for activity and demand remain uncertain.

Securities traders are feeling slightly more optimistic about their business situation, the first such positive response in two years. The sector has had a far better quarter than expected, chiefly as the result of a bouncing equity market during March, April and May. Almost all respondents report higher volumes of business – especially with retail customers – but a modest increase in activity with financial institutions is also a welcome development.

A balance statistic of +85% of traders have seen commission income climb during the quarter, even though some of this increase has been offset by lower levels of trading income. A small balance of respondents reports a recovery in profitability – the first since the beginning of the financial crisis. In addition to the spring recovery in equity markets, securities traders have been buoyed by news of HSBC's successful £12.5bn rights issue, the largest in UK corporate history⁸. There was tangible relief in

⁶ 'House prices rise for second time in three months', Nationwide, 29.05.09.

⁷ Markets Data, FT.com, 12.06.09.

⁸ 'HSBC concludes record rights issue', Financial Times, 06.04.09.

the market when the issue concluded in April, not only in response to the strong demand from investors but also because it freed up considerable capacity for other underwriting over the summer.

Not all of the sector's survey responses are positive. The sense of returning optimism is tempered with caution, and not all respondents expect the recent recovery in activity to be sustained. In fact, a small majority expect business volumes and commission income to decline over the summer months. Looking forward, the sector's longer term plans also send out mixed messages. Some houses report an increase in recruitment as they add talent in specific areas of their business, and 80% of those planning to increase capital expenditure are hoping to boost capacity. Less positively though, concerns about customer demand during the year ahead remain extremely strong. Marketing expenditure also remains on a downward trend. This confused picture may reflect the fact that institutions are adopting varying strategies and points of differentiation – for some, this may be the time to invest in their brokerage operations.

Investment management

Investment managers are feeling more optimistic for the first time in two years, but do not yet predict a real rally in business or revenues. Firms continue to cut costs, and are

paying increasing attention to sector consolidation and the threat of new regulation.

Investment managers report a strong upswing in sentiment during the quarter, moving to a positive majority view for the first time in two years. However, it is worth remembering that this represents an improvement on last quarter's sentiment, not a return to pre-crisis confidence levels. True, volumes of business are seen as having stabilised during the quarter, but this probably reflects the coincidence of the tax year end with an equity market rally. Respondents' predictions for customer demand support this view, pointing to a decline in activity over the summer months.

The improvement in equity values since March may have slowed the decline in investment management income, but the outlook for revenue remains extremely tight. The value of assets under management is far lower than the average levels of recent years, putting pressure on revenue. This is the result of lower market values and heavy investor redemptions, neither of which are likely to be reversed in the near future. The shift to lower risk assets by many investors also continues to dilute the sector's fee mix. In response, investment firms continue to reduce their cost bases. Even so, the downturn in revenue has been so extreme that profitability is still falling. Some firms may be running the risk of cutting costs to the bone.

The sector's forward looking plans are very defensive, reflecting the difficulty of winning new mandates in the current environment. Almost all respondents are focused on retaining existing customers. It is also notable that M&A is becoming a larger feature of growth plans, perhaps in response to high profile transactions such as Blackrock's planned acquisition of BGI⁹. We expect the role of M&A in the sector's plans to increase as firms' profitability comes under further pressure and consolidation accelerates. Finally, regulatory risk is climbing. Most medium and large firms are now active in the alternative space, so the proposed EU Directive on Alternative Investment Fund Managers¹⁰ is a considerable source of concern and irritation for many in the sector.

About this survey

The survey was carried out between 20th May and 3rd June 2009. 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).

⁹ 'BGI marks milestone for BlackRock', Financial Times, 12.06.09.

¹⁰ Press release, European Commission, 29.04.09.

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

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