Financial Services

Financial services survey

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

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Contents

Executive summary 04

Banking 06
Building societies 06
General insurance 07
Life insurance 07
Securities trading 08
Fund management 09

Contacts 10

Executive summary

The 75th CBI/PricewaterhouseCoopers financial services survey sees the industry's confidence falling to its lowest level since 1990. Although liquidity concerns may have eased slightly, asset write-downs remain a real concern and – most importantly – economic indicators continue to weaken. Respondents are becoming more pessimistic about the duration of the slowdown and its impact on their levels of business. It is particularly notable that worries about demand are now spreading from the consumer sector into the commercial and corporate arenas. In response to falling customer activity, cost reduction programmes are becoming more widespread and comprehensive.

Economic factors drive down sentiment and volumes

The overall level of sentiment in financial services has fallen dramatically since March, reaching its lowest level since 1990. Top-line growth is now the industry's major worry, with the data for overall sentiment increasingly correlated with volumes of business (see Figure 1). Respondents' aggregate predictions for business volumes are now the most negative in the nineteen year history of the survey.

The outlook for revenues is not the industry's only preoccupation. Asset impairments remain a real concern and are increasingly viewed as a medium-term issue, not a passing problem. In particular, lenders report growing levels of non-performing loans. However serious credit-specific concerns may be, they are rapidly being overtaken by broader economic worries, which emerge as the dominant theme underpinning the survey results.

Some rays of light pierce the gloom – financial markets have regained a degree of stability, and funding and liquidity concerns have eased slightly from the start of the year. Nonetheless, there is now near universal agreement that financial markets will not be returning to anything approaching 'normality' until 2009 at the earliest.

The slowdown is spreading to the commercial sector

All the major sub-sectors of financial services now display a negative outlook, and in most cases this is worsening, despite some individual spots of optimism in selected businesses (see Figure 2). Although activity with retail customers continues to weaken, it is the sudden downturn in business with commercial customers and financial institutions which is really eye-catching. This has great potential significance not only for the financial services industry but also for the economy as a whole.
If this represents the start of a trend, it

Figure 1: Optimism and Business Volumes

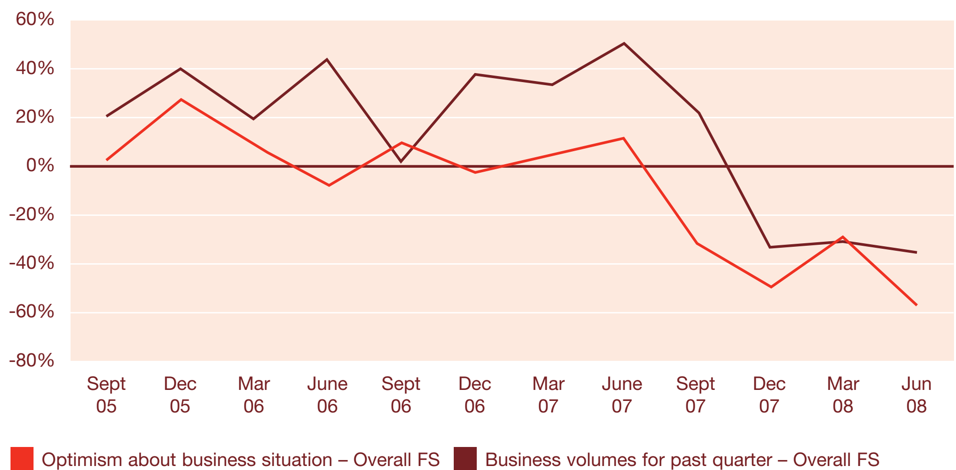
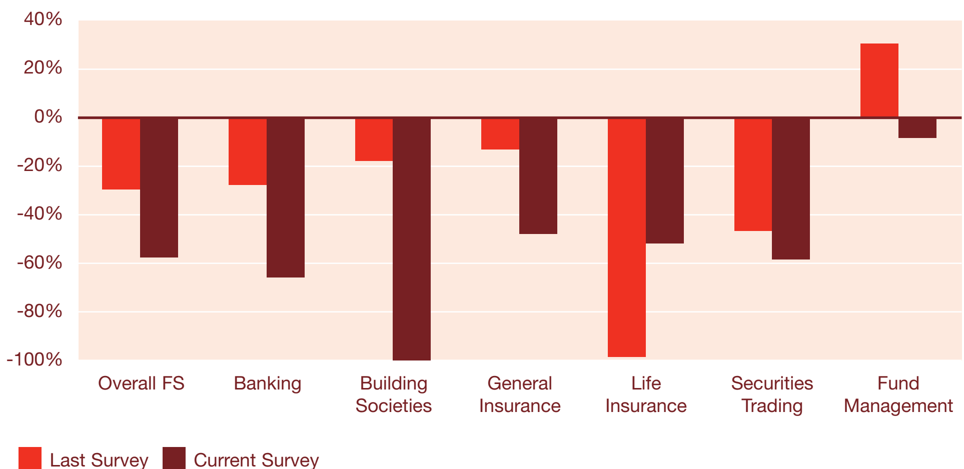


Figure 2: Optimism about overall business situation – Key sectors



could be one of the first indications that consumer retrenchment is starting to have a real effect on UK Ltd and UK plc.

Cost reduction programmes are gathering pace

Although the slowdown in activity has enabled several sub-sectors to rebuild their margins, this has been insufficient to alleviate the intense pressure on profitability being felt right across the industry. In this environment, it is hardly surprising that discretionary spending such as marketing is being heavily cut back. Capital expenditure plans are also cooling. There is a clear expectation that headcount will fall, but this is not universal; nor does it necessarily indicate plans for swingeing cuts. Finally, it is notable that despite the adverse environment all major sub-sectors are expecting to spend more on regulatory compliance in the coming year.

It is becoming evident that the slowdown in business is not merely attributable to the rapidly cooling mortgage market.

Banking

The banks are going through a period of gloom, based on slowing activity and rising levels of non-performing loans. For the first time in several years, economic worries are broadening from the retail arena to include the commercial sector. Profitability is under increasing pressure and cost reduction programmes are accelerating.

Banking sentiment has collapsed during the quarter, reaching its lowest level since 1998. The banks' concerns are broadening from the immediate problems of the credit crunch to encompass growing worries about the extent and length of the economic slowdown. Volumes of business are declining faster than had been expected, and further cooling is predicted.

It is becoming evident that the slowdown in business is not merely attributable to the rapidly cooling mortgage market. Activity with industrial and commercial customers is seen as having slowed for the first time since the start of the credit crunch. This is a significant inflexion point which could point to a more general economic deceleration, not just a tightening of household finances. It is also notable that these findings strike a more gloomy note than the banks' interim management updates (trading statements), most of which were issued before the survey was conducted. This suggests that the banks' world view is deteriorating rapidly.

The value of non-performing loans continues to grow, and credit crunch questions show that respondents see impairments of asset backed securities as an ongoing problem, not just a passing phase. The banks' continued success in rebuilding margins on many key products is encouraging, but the effects of rising arrears and falling business volumes are sufficiently powerful for banks to make their gloomiest profitability prediction since 1994.

It is hardly surprising that banks are increasingly focused on reducing discretionary costs. The outlook for employment levels remains negative and there is a sharp decline in marketing plans. If there are any grounds for optimism in these figures, they are that investment budgets have stabilised and that growth in compliance costs is seen as slowing to a more manageable pace.

Building societies

The societies are continuing to have some success in deposit gathering, which is easing funding pressure. Even so, confidence has fallen back heavily as the fast-cooling mortgage market takes its toll on lending activities. Housing arrears are also accelerating, putting further pressure on profitability – and potentially on capital adequacy.

After making a welcome rebound in March, building societies' confidence has fallen back to a wholly negative level for the second time in six months. A combination of weaker lending activity and concerns about the wider economy underpin the societies' gloomy outlook. The sector's key source of profitability – the residential mortgage market – is showing clear signs of distress. May's house price statistics from Halifax[1] and Nationwide[2] showed a monthly average UK decline of 2.4% and 2.5% respectively, and many economists are predicting further declines. In this environment demand for new mortgages is falling fast and existing borrowers are becoming

[1] Halifax House Price Index, HBOS plc – 05.06.08

[2] 'House price falls accelerate in May', Nationwide – 29.05.08

slower to remortgage, putting pressure on interest and fee income.

The societies' responses to credit crunch questions also show a rapidly increasing concern over the medium-term impact of asset impairments. It is particularly notable that a balance statistic of +50% see non-performing loans as following an upward trajectory, the sector's most downbeat view for several years. Housing arrears are clearly beginning to accelerate as borrowers refinancing their mortgages struggle with their new, higher interest payments. The sector may also be starting to worry about the impact of growing arrears on its capital ratios, since the risk weightings of mortgages now track asset quality more closely than under Basel I.

There is a slightly different story on the liability side of the societies' balance sheets. Here the sector's prudent reputation continues to attract retail deposits away from other asset classes. It is this success which drives the societies' more positive business volumes, and which gives the sector greater confidence in its ability to fund its business internally. Unfortunately, the majority of new savings generate insufficient margins to offset the effects of slowing mortgage lending and weakening asset quality. Profitability is therefore replacing liquidity as the sector's primary worry.

General insurance

General insurers report a strong downturn in sentiment and performance. Commercial lines are particularly competitive, but a belated acknowledgement of cooling economic growth is the most likely cause of the changed outlook. Revenue growth is now the sector's dominant concern. Despite an increasing focus on cost reduction, insurers are facing growing compliance expenses.

General insurers are experiencing a strong downturn in sentiment, in contrast to the previous survey when they still felt insulated from the effects of the credit crunch. The headline level of confidence has fallen to a four-year low, and is backed up by a range of abruptly downbeat responses on volumes, revenues, customer activity and profitability.

What is driving this dramatic change in sentiment? There has been no sudden shift in the ratings or claims environments since March, so a re-evaluation of the economic outlook is the most likely cause. It is true that the sector reports a slowdown in commercial lines, but this business was already on a downward pricing cycle before the current economic worries surfaced. Now, this pressure is being compounded by much broader uncertainty over future demand. Even though personal lines remain stable, the sector makes its most downbeat prediction for business volumes in almost a decade.

Worries over top-line growth also emerge clearly from the supplementary credit crunch questions. General insurers are relatively unconcerned about their ability to raise capital, but worries over short and medium-term revenue growth have intensified notably since March. The responses of insurance brokers provide further support for the general insurers' pessimistic world view. The brokers too have reached their lowest level of sentiment for several years, and report negative trends in business and revenue across all customer segments.

General insurers are responding to their new assessment of business prospects with a fresh focus on cost reduction. Marketing expenditure and investment plans are being sharply reduced. Even in the midst of this downturn however, general insurers are facing increasing compliance costs. More than half expect to spend more on this area over the coming year, as the sector faces up to continued regulatory changes including preparations for Solvency II.

Life insurance

Life insurers remain mired in gloom, and make their most pessimistic prediction yet for volumes of business. The environment of a stagnating property sector and volatile financial markets is doubly troublesome for the sector's business model.

The life insurance sector may not be feeling quite as pessimistic as in March, but it retains a strongly negative outlook for the third successive quarter. The outlook for business is strikingly poor; a balance figure of -94% report a downward trend in business volumes and almost all expect further deterioration. This is easily the most negative assessment the life companies have made in nineteen years of this survey.

Life insurers are much more dependent on their financial environment than their non-life counterparts, and the factors driving current pessimism are not hard to identify. New business is predicted to fall for the third quarter in a row, as the sector is confronted by a disastrous confluence of volatile financial markets and a slowdown in the housing sector. Investment business is threatened by market volatility, and demand for protection

Respondents are planning to commit much less capital to IT projects in the coming year, with almost all citing the cost of funding as the key limiting factor.

products is being directly affected by the rapid slowdown in house buying. Responses to the credit crunch questions underline these concerns, identifying weaker revenue growth as the biggest threat to the sector's future financial performance.

Rapid falls in equity market values since the start of the year are also putting pressure on life companies' own investment and capital plans. This is borne out by the sector's reluctance to invest in capital projects. Respondents are planning to commit much less capital to IT projects in the coming year, with almost all citing the cost of funding as the key limiting factor. Life insurers are also hoping to reduce their operating costs, with reductions in headcount and marketing as two of the major levers. Unfortunately the costs of regulation are not discretionary – despite their woes, a majority of life companies expect to spend more on compliance in the coming year.

Securities trading

Despite the relative stability of financial markets during the quarter, securities traders remain firmly negative about their business prospects. Although this picture conceals good performances from some businesses, plans for general cost reductions suggest that the sector expects the current downturn to continue well into next year.

Securities traders' confidence has declined again, completing a year of downbeat responses. At face value, the lack of improvement looks a little surprising. After all, some commentators had predicted that the Federal Reserve's intervention to rescue Bear Stearns[3] would restore some confidence to the sector. Clearly this has not been enough to prevent a further decline in business volumes; a large majority of traders also report weaker levels of activity across all customer groups. Furthermore, supplementary questions show that securities traders are the industry's most pessimistic sector in their assessment of financial market conditions – and the most concerned about the impact of falling revenues on their business.

The results are not wholly negative. It is worth remembering that the sector's responses conceal wide variations between different businesses. Investment banking and new issuance remain relatively subdued, but secondary markets are busy – especially in derivatives – and commodities desks are currently producing stellar returns. Traders are also managing to achieve higher spreads on the business they are still doing. Nonetheless, the impact of falling volumes remains more than sufficient to offset any pricing improvements, and profitability fell for the third consecutive quarter.

Securities traders are increasingly focused on re-calibrating their cost bases for a lower-volume world. The level of respondents reporting cuts in total operating costs is the highest since the bear market of 2002. Although the sector remains wary of cutting its workforce too far, too fast, headcount forecasts have deteriorated further. Training expenditure is also widely predicted to shrink. Marketing budgets have been cut back heavily, and it is particularly striking that IT investment plans have moved to a negative balance. This follows sixteen consecutive quarters of investment in trading platforms and back office systems, and gives a strong indication of just how seriously

[3] 'Fed leads Bear Stearns rescue', Financial Times – 15.03.08

securities traders are taking the current downturn.

Fund management

Fund managers' sentiment has declined, becoming more closely aligned with that of other sectors. Despite a successful quarter of asset gathering – with foreign customers a key source of new funds – the outlook is bleak and profitability is under pressure. Even so, the sector remains characteristically upbeat in its plans for increased headcount and higher marketing expenditure.

Sentiment among fund managers has shifted downwards to a slightly negative stance. This more sanguine assessment reflects the sector's mixed view of its own prospects, and moves the fund managers' headline outlook more into line with the rest of the industry.

On a positive note, fund managers report surprisingly healthy activity for the past three months. Global equity markets have enjoyed a more stable second quarter – admittedly with wide variations between industries – and this relative calm helped fund managers to report a positive trend in volumes of business. This response tallies with the Investment Management Association's fund flow statistics for April[4]. These showed a marked recovery in net institutional sales, which reached £722m in April from just £3m in March. It is also particularly interesting to see that respondents to the survey attribute much of their recent business to overseas customers. Where are these funds coming from? Considering the current direction of global capital flows, the most likely sources are probably the fast-growing Asian economies and the petrodollars of the Middle East.

Whatever the origins of overseas business, fund managers must be hoping it will help to offset weaker demand at home. Respondents are far less upbeat when considering future revenues, and in a world where consistent yields are getting harder to achieve, they are increasingly worried about fee pressures. This concern is evident in the falling profitability reported by a balance statistic of -80%, the most negative such response since the bear market of 2002.

In this environment, it is surprising that the sector has not yet developed concrete expense reduction plans. Remarkably, a strong majority predict headcount growth, and three quarters of respondents plan to spend more on marketing. In the latter case, the sector is probably trying to spend its way out of trouble by retaining and building on its existing valuable institutional relationships.

About this survey

The survey was carried out between 21st May and 4th June 2008.
A total of 87 companies responded including banks, building societies, finance houses, securities traders, fund 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).

[4] Investment Fund Statistics April 2008, Investment Management Association – 28.05.08

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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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