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Industry sentiment

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The 89th CBI/PwC Financial Services Survey shows a further decline in confidence, but volumes of business are growing in some sectors

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Executive summary

The 89th CBI/PwC financial services survey shows a further decline in industry confidence, although volumes of business are growing in some sectors. The uncertain economic outlook casts a shadow, with aggregate employment falling and non-performing loans reported to be growing. Regulation remains a preoccupation for many, and constraints on funding are an emerging concern for some.

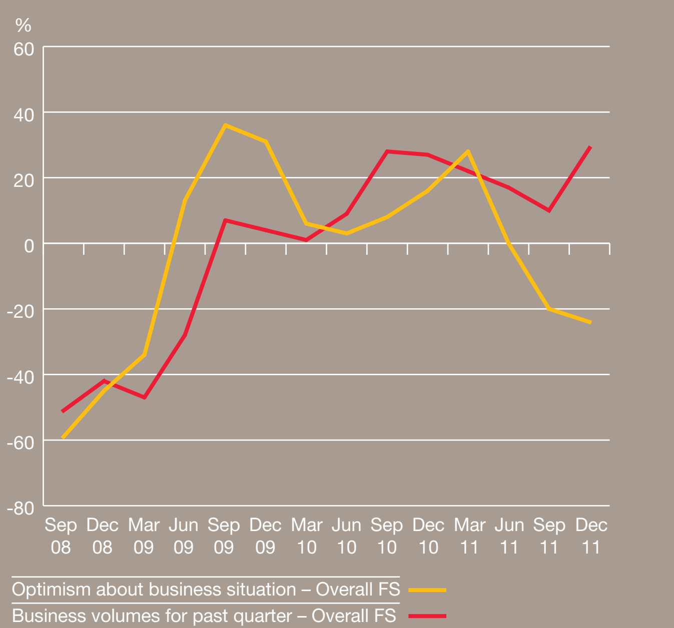
Confidence continues to fall, but volumes of business are still growing in some sectors

Overall confidence in the UK financial services industry has fallen further during the quarter, proving that September's sudden decline in sentiment was no fluke. However there has been a marked disconnection between weaker headline sentiment and stronger aggregate volumes of business (see Figure 1).

Negativity about the overall business situation extends to every corner of the industry, but there is a real contrast between sub-sectors (see Figure 2). Some, such as the building societies and life insurers, are feeling more downbeat than before, but others, including the banks and general insurers, have returned to a comparatively stable view.

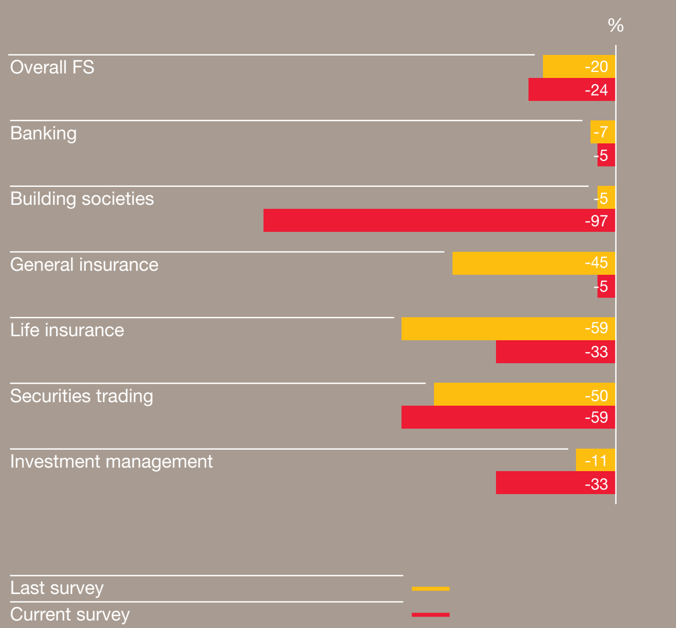
In part, the disconnection between sentiment and performance reflects a mixed outlook for the first quarter of 2012 (see Figure 3). Again, there is considerable variation between sub-sectors, reflecting uncertainty over the short-term economic outlook. Some sectors expect an improvement in business, while others fear a drop-off in activity. The strong weighting given to banking responses means that these contrasts are partly concealed in the aggregate data.

Figure 1: Optimism and business volumes



Source: CBI/PwC Financial Services Survey, December 2011.

Figure 2: Optimism about business situation



Source: CBI/PwC Financial Services Survey, December 2011.

Employment trends are to the downside, and non-performing loans show signs of expanding

As predicted in the previous survey, aggregate numbers employed are reported to have declined during the past three months. Further reductions are expected for the coming quarter. The overall decline would have been stronger were it not for reports of higher staffing among building societies, life insurers and securities traders, although low staff turnover offers a partial explanation for this.

Overall profitability is seen as increasing, but once again this conceals a wide variation between sub-sectors. Some had a very disappointing quarter, while others have seen their profitability climb. The survey shows a potentially worrying increase in the value of non-performing loans, although the banks and building societies take opposing views as to how this trend will develop.

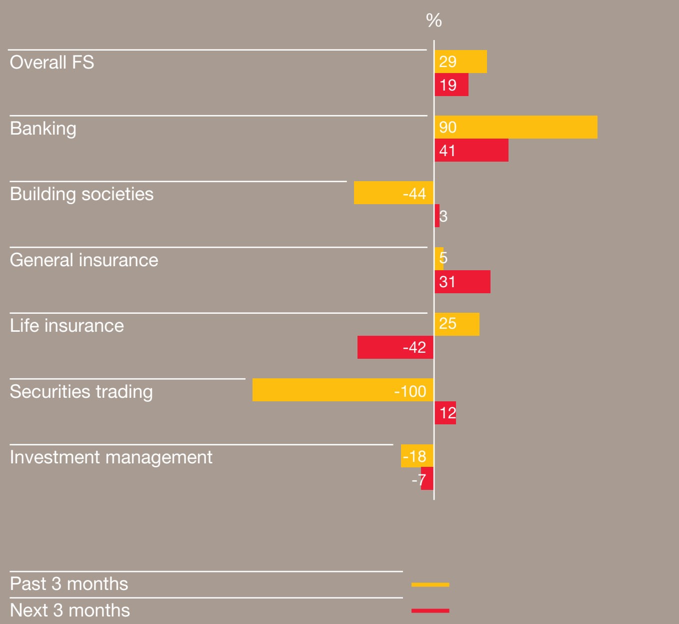
Firms are facing the Eurozone crisis, the need to innovate and a surge of new regulation

Looking at the wider picture, there is no doubt that the sovereign debt crisis continues to overshadow the industry. Market volatility is having a negative effect on confidence and customer demand, and some sectors are also seeing a very clear impact on their ability to fund themselves. It is a long time since many respondents predicted a return to 'normal' financial market conditions, but it is notable that increasing numbers see a high likelihood of further deterioration in the financial markets (see Figure 4).

If the industry sees little prospect of an improvement in its operating environment, it shows equally few signs of revisiting its current business models. There are some encouraging signs of investment in new products, but little indication of a widespread push for innovation.

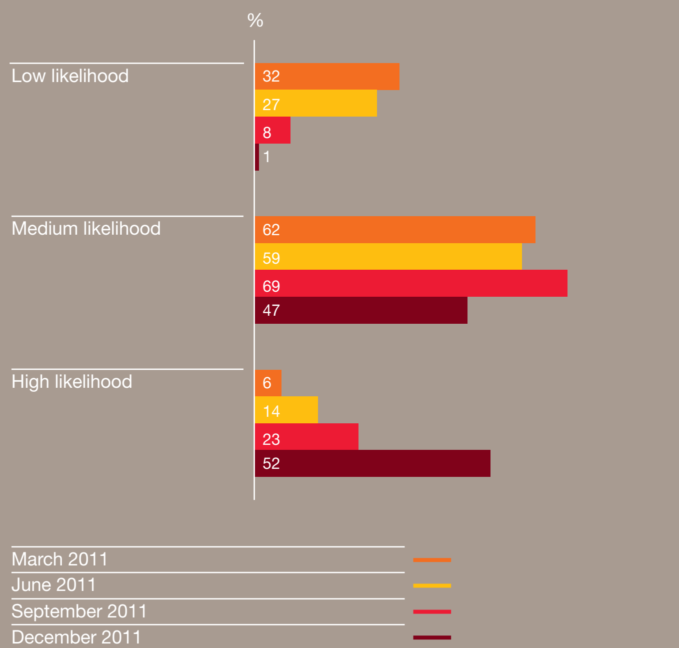
In contrast, there is a clear expectation that the costs associated with regulation will only continue to grow. Investment managers in particular face a busy year for compliance, but there is not a sub-sector of the industry that expects to be untouched by the wave of new regulation.

Figure 3: Trends in volumes of business



Source: CBI/PwC Financial Services Survey, December 2011.

Figure 4: Likelihood of further market deterioration



Source: CBI/PwC Financial Services Survey, December 2011.

More positively, most banks report a surprising increase in their volumes of business and the value of income.

Banking

The banks face increasing competitive pressures, but report surprisingly buoyant levels of business. Profitability is also growing, although regulatory spending continues to climb and staffing reductions are planned. The banks are increasingly keen to pass on their funding costs to customers.

The banks continue to feel less optimistic, reflecting concerns over the economic and regulatory landscape in which they operate. The political environment is also having a strong effect on sentiment. However, there is an increasing disconnection between pessimism and performance. Several of the banks' other survey responses suggest that the sector is far from being on the ropes.

The banks are increasingly concerned about competition. This reflects the fact that the current quarter has seen not only the publication of the Independent Commission on Banking's final report, but also the sale of Northern Rock to Virgin Money. Add to this the anticipated sale of more than 600 Lloyds branches, and it is not surprising that almost all respondents see competition as a growing threat. New entrants are a source of real concern, and almost half of those surveyed anticipate additional competition from non-financial services companies.

More positively, most banks report a surprising increase in their volumes of business and the value of income. Further improvements are predicted, perhaps reflecting hopes that lending incentives outlined in the Chancellor's Autumn Statement will stimulate new credit approvals. It is also notable that activity with both commercial and retail customers is now seen as growing. This had been predicted, but remains a very encouraging response in the context of falling GDP forecasts for 2012.[1] These improvements help the banks to report solid profitability trends, although this comes at the cost of further reported reductions in headcount.

The survey produces some other interesting responses. The banks report a significant change in the outlook for average spreads, showing a strong desire to pass on their growing costs of funding. In reality, the sector will probably struggle to broaden its net interest margins. Even so, this response reflects the banks' growing belief that improving price control is vital to successfully rebalancing their business models. Despite the sector's commitment to cost control, there is near-universal agreement that regulatory spending will increase during the coming year.

1 PwC, *UK Economic Outlook*, November 2011.

Building societies

The building societies are facing weak demand, tough competition and growing funding pressure. Non-performing loans are seen as trending upwards, and compliance costs are rising. Even so, there are some encouraging signs, including a surprising prediction for reduced pressure on margins.

The building societies report overwhelming pessimism, with a balance statistic of -97% feeling less confident about their business situation. This negative outlook is consistent with the societies' other responses to the survey, which paint a picture of weak business and declining levels of income. Falling activity with the crucial retail segment is a particular source of concern. Despite tightly controlled operating costs, weak headline performance is damaging profitability. A reported increase in headcount is a surprising response, although this had been predicted by some. It may also be explained by lower than anticipated turnover of staff during the quarter.

Fortunately, the outlook for the first quarter of 2012 includes some slightly more encouraging signs. Marketing expenditure is predicted to continue to grow, as is capital expenditure on IT. Most respondents also expect new products to stimulate growth during the coming year.

More surprisingly, the societies expect to see average spreads widen during the coming quarter. It is true that many in the sector would like to see a return to more sustainable pricing, but it is hard to see where margin expansion will come from in the next three months. Base rates remain low, competition from the banks is tough and the societies identify the availability of funding as an increasingly serious threat.

Less positively, respondents report a sudden increase in the value of non-performing loans. This does not indicate a significant jump in arrears, but it points to deteriorating credit performance and growing concern about unemployment. The fragility of house prices is another worry. A material decline in average values would accelerate the translation of non-performing loans into impairments. Regulatory spending is expected to increase by almost all respondents, and may reflect the Financial Services Compensation Scheme's need to refinance its current loan from HM Treasury during the coming quarter.

Fortunately, the outlook for the first quarter of 2012 includes some slightly more encouraging signs.

General insurance

General insurers report a stable outlook, balancing the negative effects of domestic retail competition with the possibility of stronger commercial activity. In contrast, insurance brokers take a far more negative view of their business situation.

Following a steep fall in sentiment in September, general insurers have returned to a more stable outlook and report some of the current survey's most neutral responses. At one level this is not unusual for a sector that is typically less sensitive to the economic cycle than many of its financial services counterparts. More immediately, insurers' steadier sentiment reflects their stable assessments of business volumes and premium income. These suggest that rates have not softened significantly over the past three months, although there is no doubt that many insurers are still struggling to achieve price increases.

The intense competition for domestic retail business emerges even more clearly from insurance brokers' responses to the survey.

General insurers expect business and premium income to pick up during the coming quarter, but commercial lines are expected to outperform personal business. This reflects intense competition in the retail market, especially in home, motor and other large classes of business. The effects of this competition can be seen in the sector's falling profitability, although higher operating costs and falling levels of investment income are also at work. The insurers continue to plan further reductions in headcount as they respond to current market conditions. The sector's hopes for the early part of 2012 not only rely on growth in commercial lines but also on an anticipated – and very welcome – recovery in business with overseas customers.

The intense competition for domestic retail business emerges even more clearly from insurance brokers' responses to the survey. Competitive forces are combining with the impending introduction of the Retail Distribution Review regime at the end of 2012 to put the sector under exceptional pressure. The result is the lowest level of broker sentiment for several years, coupled with an extremely strong decline in profitability.

Life insurance

Life insurers report a stable quarter of activity, but make much more downbeat predictions for the coming quarter. Investment market volatility and tighter household budgets are expected to hurt income and profitability, but the sector reports a surprising increase in headcount.

New business, which had been predicted to fall, is also seen as having grown by a small balance of respondents.

Life insurance sentiment continues to decline, albeit at a slower rate than in the last survey. Even so, the current set of responses show ample reason for pessimism. True, the current quarter is reported to have seen some growth in volumes of business and a modest increase in premiums. New business, which had been predicted to fall, is also seen as having grown by a small balance of respondents. But life insurers now predict a significant downturn in activity for the first quarter of 2012 and forecasts for the value of income are clearly to the downside.

The change in direction is particularly marked in the retail sector. Business in this segment is expected to fall by a balance statistic of -37%, the most negative response since March 2009. This reflects an unhelpful combination of falling consumer confidence, a quiet housing market, tighter household budgets and volatility in the investment markets.

The result of the predicted downturn in activity is an anticipated shift in profitability from a positive balance of +31% in the current period to one of -42% for the coming quarter. The sector continues to keep operating costs under tight control, so a reported increase in numbers employed comes as a surprise. There is no obvious reason why the life companies should be adding staff at present, but this may reflect a sharp reported decline in turnover. Employees are clearly choosing to sit tight rather than test the current employment market.

Regulation remains a major preoccupation for life companies, and is identified as the leading driver of capital expenditure on IT. At the same time, growth in compliance-driven spending is slowing as Solvency II deadlines extend and related projects are incorporated into business-as-usual budgets. An expectation that investment in sales channels will deliver growth during 2012 provides a hint of optimism as the sector considers its response to the Retail Distribution Review.

Securities trading

Securities traders continue to feel the effects of the sovereign debt crisis, with all respondents reporting lower levels of business. Predictions for the coming quarter are slightly more positive, but regulatory change and increasing constraints on capital are seen as growing concerns.

Corporate clients are seen as offering scope for growth…

The ongoing crisis in the Eurozone continues to cast a shadow over securities trading firms, with a balance statistic of -59% feeling less optimistic. Volumes of business are reported to have fallen by all respondents for the first time in the survey's 20-year history. A strong majority also see commissions as having declined during the quarter. These responses reflect the impact of market disruption on equity underwriting and transaction advice, although low yields are encouraging some clients to issue debt.

Despite these negative responses, predictions for the coming quarter are slightly more positive. Corporate clients are seen as offering scope for growth, with many companies expected to review their financial requirements during the first quarter of the year.

In contrast, securities firms report a striking reduction in business with financial institutions. This is a reflection of systemic concerns and tightening in the inter-bank market, with less capital being made available to trading desks. It is notable that the availability of funds has jumped up the rankings of business threats since the last survey.

Securities firms report heavy downward pressure on profitability, and are tightening their belts in response. Capital expenditure on IT is also expected to fall as it becomes harder to develop a business case for investment. That said, a high proportion see investment in IT as an element of their overall growth strategy.

It is notable that nearly half of those surveyed do not expect to grow their business during 2012. Most brokers plan to focus on customer acquisition and retention during the coming year, but some also hope new products will deliver growth. A strong majority expect regulatory spending to expand. Publication of the MiFID II draft during the quarter and the emergence of regulatory clarity on EMIR and associated requirements in the coming year are helping brokers to develop a clearer view of the impact of new regulation on their businesses.

The coming year is likely to be one of exceptional compliance efforts.

Investment management

Investment management revenues are suffering from falling markets, net outflows and the allocation of capital to low-fee assets. In response, firms appear to be focusing on their core activities and shying away from expansion. The coming year is likely to be one of exceptional compliance efforts.

Investment management sentiment has declined further, with a balance statistic of -33% feeling negative about their business situation. This reflects a clear deterioration in top-line performance. Fee income, which held up surprisingly well during the summer, is now seen as having fallen by a strong balance of respondents. Declining fees are the inevitable result of two factors: falling market values and net fund outflows. Business with individual investors is particularly weak, with retail activity expected to continue falling into the New Year. This is consistent with the picture of strong outflows seen across the European fund industry over the autumn.[2] Revenues are taking a further hit from investors' shift into cash, which generates low fees, and from the comparatively rapid growth in ETFs and other low-cost beta products.

Despite continuing efforts to reduce operating costs, poor revenue performance is taking a toll on investment managers' bottom line. A balance statistic of -38% see profitability declining and, as predicted, the sector reports lower levels of staffing. Capital expenditure continues to grow, but this is oriented towards replacement and efficiency improvement. Taken together, these responses paint a picture of retrenchment and a focus on defending the viability of core activities. This is an understandable goal given the negative market reaction to managers announcing disappointing results in recent weeks.

All investment managers identify weak demand as a potential threat to their business during the coming year. It is therefore slightly worrying that the survey results give no clear indication of how the sector plans to generate new growth. Expansion appears to be receiving less emphasis than in recent quarters, and enthusiasm for new products or services is comparatively low. This supports the impression that, for now at least, investment managers are concentrating on reinforcing their areas of greatest strength. However there is one area they cannot ignore – regulation. The coming year could be the most compliance-intensive in the sector's history, and regulatory spending plans are growing accordingly quickly.

2 *EFAMA*, October Factsheet, 12.12.11

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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 is £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:

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About this survey

The survey was carried out between 21st November and 7th December 2011. A total of 106 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).

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