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Industry sentiment

Financial Services Survey

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

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The 90th CBI/PwC financial services survey shows a strong recovery in confidence, with all major sub-sectors feeling more optimistic.

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Executive summary

The 90th CBI/PwC financial services survey shows a strong recovery in confidence, with all major sub-sectors feeling more optimistic. The improvement reflects continued growth in volumes of business, calmer financial markets and more stable economic forecasts. The outlook for employment has also picked up significantly. Firms are focusing on their plans for growth, but regulation is also a major driver of spending.

Confidence rebounds strongly, aided by growing volumes and calmer financial markets

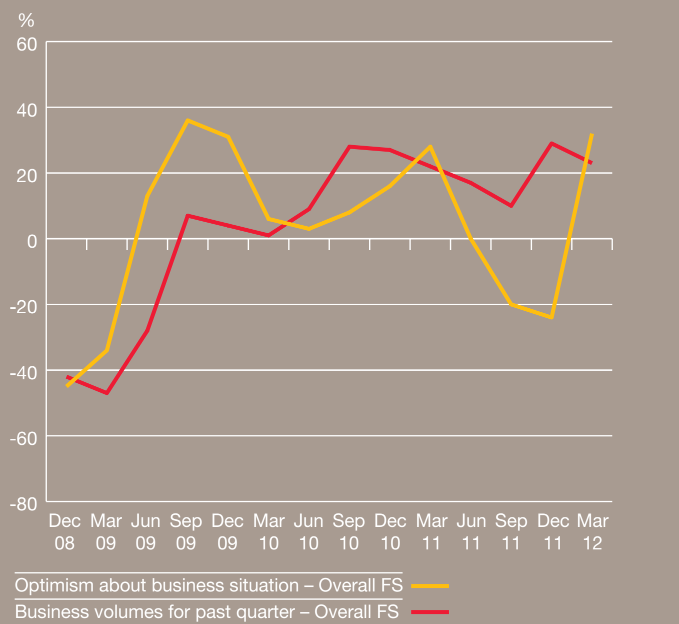
The UK financial services industry has undergone its strongest positive swing in sentiment since the end of the 2008 bear market (see Figure 1). This improvement not only reflects continuing growth in aggregate business volumes, but also a more stable macro environment.

In December, the crisis in the eurozone and an uncertain economic outlook were overshadowing industry sentiment, despite continued growth in volumes of business. Since then a number of data releases have suggested that UK economic conditions may not be quite as weak as had been feared. Forecasts for growth in 2012 remain low, but consensus figures remained stable in February and inflationary pressures have eased slightly.[1]

The European Central Bank's Long Term Refinancing Operation (LTRO) has also calmed financial markets, and is widely seen as having reduced the immediate risk of a fresh liquidity crisis among European banks. The overall effect has been a marked improvement in funding conditions.

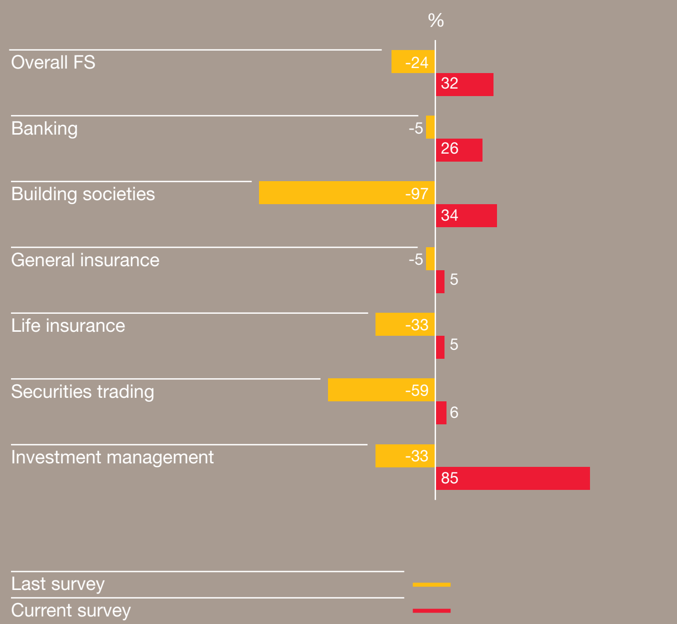
1 HM Treasury, *'Forecasts for the economy: A comparison of independent forecasts'*, 21.02.12.

Figure 1: Optimism and business volumes



Source: CBI/PwC Financial Services Survey, March 2012.

Figure 2: Optimism about business situation



Source: CBI/PwC Financial Services Survey, March 2012.

The dramatic improvement in overall industry confidence is mirrored across the sub-sectors of financial services, with each major sector reporting a shift from negative to positive sentiment – even if the size of the swing varies considerably (see Figure 2). Most also expect their current growth in volumes of business to continue into the coming quarter. Life insurers and investment managers are particularly bullish. Securities traders, more exposed than most to the effects of financial market volatility, are the exception to this rule (see Figure 3).

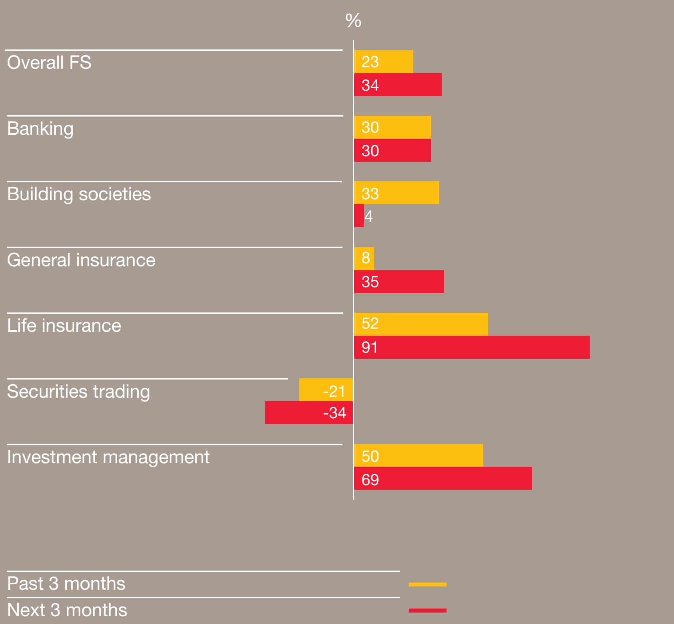
The outlook for employment is improving, but attracting talent is a concern for some firms

The industry's improving sentiment and predictions for stronger activity are carrying over into other areas. Arguably the most important of these is employment. At the last survey in December, aggregate numbers employed across UK financial services were seen as falling, and further reductions were predicted for the first quarter of 2012.

In fact, overall levels of headcount are reported to have grown during the past quarter, with a particularly strong increase in the banking and insurance sectors (see Figure 4). Furthermore, numbers employed are expected to expand further over the next three months, with banks, building societies and insurers all planning to increase their levels of staffing. This not only reflects stronger levels of business, but also the requirements of new regulation and the need to invest for organic growth.

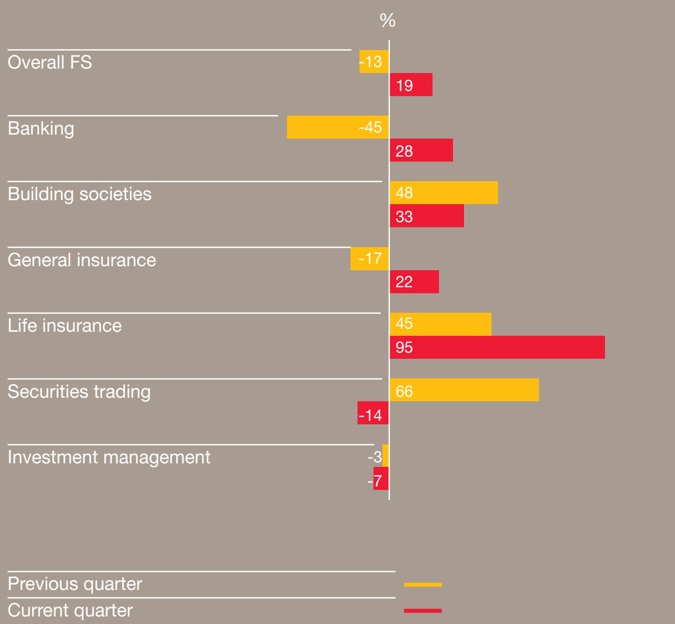
Even so, the survey shows that some respondents see the availability of professional staff as an increasing limitation on business. This may be a reaction to stronger hiring intentions, but it might also reflect concern that reputational damage to financial services could make it harder to attract the best staff.

Figure 3: Trends in volumes of business



Source: CBI/PwC Financial Services Survey, March 2012.

Figure 4: Trends in numbers employed



Source: CBI/PwC Financial Services Survey, March 2012.

The banks now sound a confident note on their own business prospects.

Banking

The banks are increasingly confident about their overall business prospects, reporting wider margins and stronger revenues. Assessments of credit risk have improved and staffing plans are on the increase. The sector is planning to invest in IT to stimulate future growth.

Banking sentiment has recovered strongly since December, when a possible break-up of the Eurozone and weakening economic prospects cast a long shadow over the sector. Since then, the banks' mood has been boosted by slightly better economic data and the European Central Bank's LTRO, reducing the prospect of an immediate liquidity crunch. The banks now sound a confident note on their own business prospects. Activity with retail and commercial customers is growing – an encouraging sign for the UK economy – and volumes of business continue to increase.

Despite their improving sentiment, the banks still face some challenges. Total costs are climbing and the availability of funds remains a concern for some respondents. However, average spreads have expanded again, highlighting the banks' determination to broaden their net interest margins in the face of persistently low base rates.

Replies to the survey reveal two other encouraging responses. First, the banks are feeling more confident about their customers' creditworthiness. After reporting an increase in non-performing retail loans in December, respondents now take a more sanguine view of the outlook for both retail and commercial asset quality.

Second, the banks' employment plans have changed direction. Where a strong balance statistic had predicted lower levels of staffing, respondents now report increasing headcount and further plans for recruitment. This reflects a number of factors, including the growing compliance burden and efforts to improve complaints handling. As they adjust to slower economic growth, the banks are also increasingly keen to invest in digital services and other innovations aimed at improving the customer experience and boosting organic growth.[2]

2 PwC, '*The New Digital Tipping Point*', 17.02.12.

Building societies

Building societies report a surprisingly strong rebound in confidence, encouraged by a pick-up in activity with retail customers. Unfortunately the outlook for growth and asset quality is not so positive. Despite wider average spreads, funding is a continued source of concern.

Building societies report the strongest rebound in sentiment of any sub-sector. Much of this can be attributed to the easing of the eurozone crisis, but some mild improvements in the UK housing market may also have played a role. Bank of England data for January showed a higher number of home loan approvals than in any month since December 2009,[3] and at least one major house price index has strengthened slightly during the first two months of the year.[4]

The societies' volumes of business have recovered during the quarter. This is welcome if slightly surprising, but might reflect the upcoming end of the first time buyer stamp duty holiday. The societies also make upbeat predictions for profitability.

The societies also make upbeat predictions for profitability.

Unfortunately, the broader outlook is less encouraging. Inflation may be falling, but growing unemployment and potential issues around affordability are casting a shadow, and a majority of respondents do not expect their business to grow during the coming quarter.

Funding appears to be an area of contradiction. The ability to raise funds is an increasing concern, but most of those surveyed say that average spreads are growing. This implies that while pricing decisions have improved margins in the immediate term, the level of competition for retail deposits remains a concern.

The societies take an increasingly negative view of asset quality. Despite low levels of arrears[5] – and in contrast to the banks – growing unemployment, the impact of the Government's austerity measures and the spectre of worsening customer affordability metrics are troubling the sector. The societies also remain concerned about the costs of regulation. Compliance spending is expected to grow strongly, as the societies anticipate the FSA's introduction of a 'twin peaks' approach.

3 Bank of England, *'Lending to individuals – January 2012'*, 20.02.12.

4 Nationwide, *'UK house prices edge up by 0.6% in February'*, 01.03.12.

5 CML, *'2011 repossessions lowest since 2007'*, 09.02.12.

General insurance

General insurers report a modest improvement in sentiment, backed up by a stronger top line performance. Commercial and overseas demand disappointed during the quarter, but claims growth is slowing and the sector is once again planning to boost its headcount.

General insurers are feeling slightly more confident after the last quarter's modest decline in sentiment.

General insurers are feeling slightly more confident after the last quarter's modest decline in sentiment. More encouragingly, they also report growing volumes of business and stronger revenues. Given the ongoing pressure on underwriting profits – especially in personal lines – this is particularly welcome. Respondents expect further improvement for the coming quarter, suggesting that some hope to achieve a sustainable increase in rates.

Stronger volumes and pricing are helping to boost profitability, which has picked up for the first time in several quarters despite indifferent growth in investment income. The improvement in profitability is all the more surprising given respondents' negative assessments of customer demand. Commercial business is reported to have fallen for the first time since 2010, a disappointing result that could point to a weak set of year-end renewals. In contrast, activity with private individuals remains flat. Total operating costs are rising but remain controlled, and the sector's profitability is predicted to strengthen further over the next three months.

The survey provides several other reasons to be cheerful. First, the sector reports an increase in headcount, a welcome change after two quarters of staffing reductions. Second, claims growth is slowing at last and respondents expect the value of claims to fall over the coming quarter. This suggests that high profile efforts to reduce fraudulent claims may be bearing fruit, coupled with the prospect of a change in the law for bodily injury claims. Third – and despite the approach of Solvency II – regulation is identified as a relatively minor concern.

Looking further ahead, the insurers are increasingly optimistic about their ability to grow via domestic customer acquisition. Hopefully this will make up for the lower reported levels of overseas business, which failed to live up to December's expectations.

After a period in the doldrums, life insurance sentiment has returned to positive territory.

Life insurance

The life insurance sector reports a strikingly positive set of results, including growing customer demand and stronger levels of new business. The life companies are planning to add staff and invest more capital as they plan their responses to the introduction of the Retail Distribution Review.

After a period in the doldrums, life insurance sentiment has returned to positive territory. This improvement is backed up by a remarkably bullish set of survey responses. A majority of those surveyed experienced stronger volumes of business during the quarter, and a balance statistic of +95% see new business as having increased. In both cases, further improvements are forecast.

These surprisingly confident views are supported by an upbeat assessment of customer demand, suggesting a bias towards UK business among a few key respondents. In the corporate arena, this probably reflects stronger group pensions business. On the personal side, single premium contributions by high earners before the Budget may provide the explanation. This would also account for the reported fall in commissions paid, at a time when overall costs are increasing.

The life companies' confidence is not limited to their predictions for business and revenue. Employment intentions are extremely strong, building on the increase reported in the previous survey. Respondents also see the availability of both professional and clerical staff as an increasing challenge. This not only reflects the reported boom in new business, but also the range of investment and regulatory projects the life companies are undertaking. Capital expenditure on IT is on an upward track, driven not just by regulation but also by the search for efficiency and the need for replacement.

Looking further ahead, it is notable that investment in marketing, performance measurement and IT are seen as increasingly crucial to growth during the coming year. This gives an indication of how patterns of business are likely to change with the introduction of the Retail Distribution Review. The need for life companies to revisit their distribution strategies is also illustrated by respondents' growing concerns about competition from other sectors of financial services.

Securities trading

Securities traders' sentiment has stabilised, but their overall mood remains unquestionably downbeat. Levels of business are falling and there is increasing uncertainty over future demand and the long-term impact of regulatory changes. In response traders have begun to reduce staffing.

Securities traders' sentiment has stabilised, following three quarters of decline. The sense of crisis that hung over the sector in December, when traders were fearful of a eurozone break-up, has retreated. Even so, securities traders' responses give an overall impression of resignation. A uniformly negative assessment of top line prospects sets the tone, with volumes of business and the value of income seen as following a downward path. Hoped-for growth in commercial demand has not materialised, and activity with other customer segments is seen as falling despite the relative stability of markets during the first quarter of the year.

The picture is not much more encouraging on the expense side. Although total operating costs are being trimmed, falling activity means that average costs per transaction continue to climb. Despite the introduction of the LTRO, which has eased funding concerns and offers the potential for easy 'carry', profitability has fallen and is expected to remain under pressure. In response, securities traders are reducing their headcount and are planning to cut marketing and other discretionary spending. There is also a sense that capital investments are hard to justify when economic and regulatory factors are making returns so uncertain.

Looking ahead, the sector's downbeat predictions for growth reflect the backdrop of regulatory change and the resulting uncertainty over the sustainability of current business models. Implementation of the Volcker rule and the Vickers ring-fence designed to restrict proprietary trading could have an adverse effect on repo markets. This is increasing securities traders' uncertainty about their long-term outlook, and there is concern that these and other regulatory reforms could have a dampening effect on innovation in the sector.

Securities traders' sentiment has stabilised, following three quarters of decline.

Investment management

Investment managers report a strong return to confidence, aided by buoyant levels of business and strong demand from other financial institutions. The sector continues to focus on cost reduction, but spending on regulatory compliance looks surprisingly low.

Demand from financial institutions is identified as the key driver of business growth.

Investment managers report a sudden improvement in sentiment, with a balance statistic of +85% feeling more optimistic about their business situation. Equity market values may have bounced back since the last survey in December, but the sector's reaction is so strong that it is hard not to feel that hope is gaining the upper hand over reality. Alternatively, investment managers' recovery in confidence could be interpreted as relief that the European Central Bank's intervention has had such a calming effect on financial markets.

Even if the headline level of sentiment is exceptionally high, it is notable that investment managers also give several other surprisingly positive responses. At least half of those surveyed report stronger volumes of business for the past quarter, and a majority expect growth to continue. Demand from financial institutions is identified as the key driver of business growth, suggesting that investment managers are hoping to capitalise on the increasingly positive mood among their life insurance clients.

Investment managers are making some progress with their cost reduction plans, although this means they are one of the few sub-sectors to predict reductions in headcount for the next three months. Combined with the increasing volumes of business, lower operating costs mean that a strong majority of investment managers see their profitability as being on the increase. Marketing expenditure is one exception to the rule, and is expected by almost all respondents to expand during the coming year. This can be tied in with growing interest in the potential for product innovation as a driver of organic growth.

The sector's focus on cost management may be reassuring, but investment managers' low reported levels of compliance spending are hard to believe. No investment manager will be unaffected by the unprecedented wave of new regulatory regimes – domestic and foreign – sweeping towards the industry over the next two years.

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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 23 February and 8 March 2012. A total of 95 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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