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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 93rd CBI/PwC Financial Services Survey reveals a picture of stronger confidence and profitability, tempered by economic uncertainty.

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Executive summary

The 93rd CBI/PwC financial services survey shows a marked and very welcome improvement in confidence across the industry, fuelled by strengthening profitability and predictions for stronger revenues in 2013. Even so, the effects of job cuts on skills and managerial capabilities are being felt by several sectors, particularly the banks. Uncertainty over regulation and the economic recovery also suggest that the industry's newfound confidence could yet prove to be fragile.

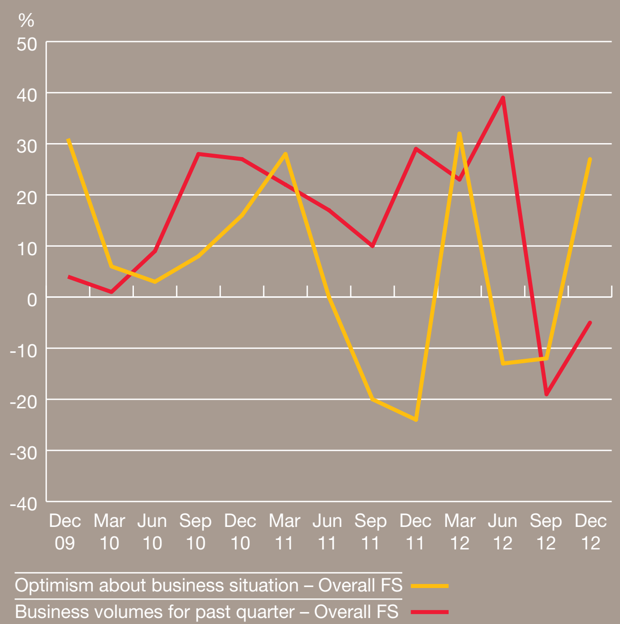
Financial services confidence undergoes a significant – and unexpected – improvement

After two quarters of declining confidence, UK financial services firms report a remarkable return to rising optimism (see Figure 1). Although this owes a lot to a strong improvement in banking sentiment, it is notable that every major sub-sector of the industry apart from securities traders feels more confident than three months ago. This is a near-reversal from the previous survey, when investment managers were the only sector seeing rising sentiment about their business situation.

The change in mood reflects a variety of factors. Some are obvious, such as the slower decline in aggregate volumes of business after the steep decline reported in September (see Figure 1). The steadier UK economic outlook may be playing a role too. At the time of the last survey growth forecasts were being rapidly revised downwards, but more recent data suggests that economic growth has broadly stabilised.[1] Employment rates are also holding up better than many economists had expected. Other less tangible factors could include the comparative stability of European financial markets during the quarter, or a marginal improvement in the tone of political and media commentary on the industry.

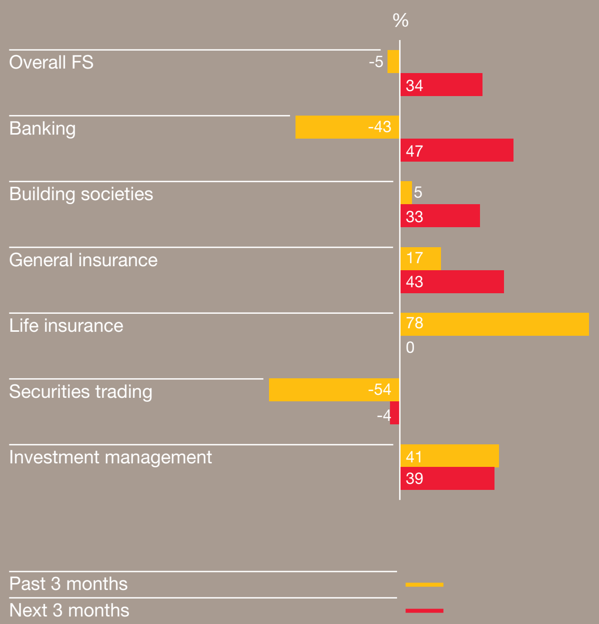
1 *'Forecasts for the UK economy'*, HM Treasury, 19.12.12.

Figure 1: Optimism and business volumes



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

Figure 2: Trends in volumes of business



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

Firms expect stronger volumes and profitability for the first quarter of 2013

The improvement in headline confidence is not the only encouraging finding to emerge from the survey. Respondents are predicting a pick-up in activity for the first quarter of 2013. Forecasts for stronger growth in business volumes are particularly striking, and are widely shared across the industry (see Figure 2). Banks, building societies, general insurers and investment managers all anticipate significant increases in business for the coming quarter. Firms' predictions for stronger volumes are supported by a sharp increase in planned marketing expenditure in the year ahead, relative to the past twelve months.

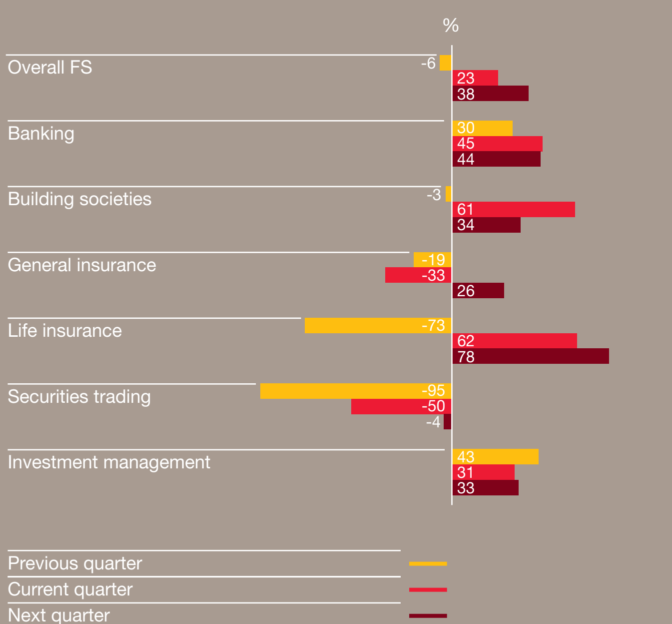
The overall profitability of financial services firms is also undergoing a turnaround. Profitability has improved in several sub-sectors, with further improvements forecast for the coming quarter by almost all respondents (see Figure 3). This not only reflects the anticipated improvement in volumes of business, but also the industry's continuing commitment to cost reduction.

Even so, job cuts, the effects of de-skilling and regulation cast a long shadow over the industry

Cost reductions across financial services are having an inevitable effect on numbers employed. This is especially true in the banking sector, where further job cuts are reported by almost all respondents. It is therefore interesting to see that banks and others are growing concerned about the effect on their skills base, and on their ability to invest effectively for the future. More positively, the survey suggests that banking job cuts may be partially offset by stronger rises in employment in other areas of the industry (see Figure 4).

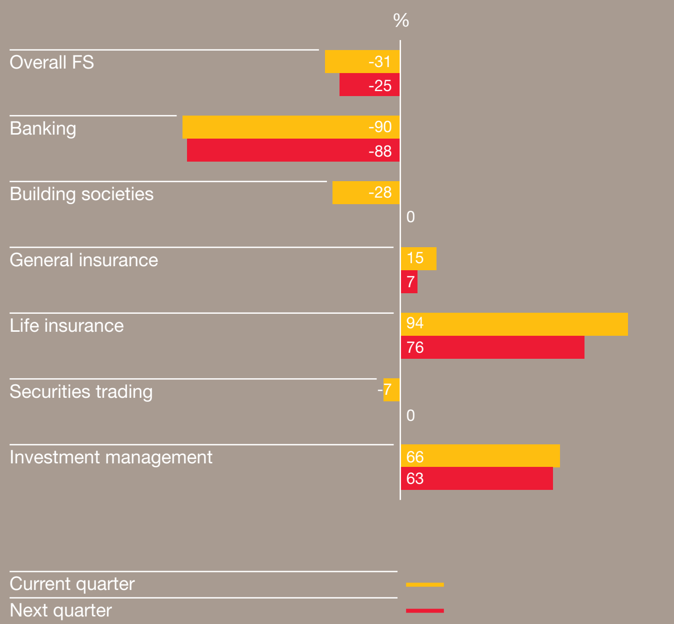
Looking ahead, those surveyed identify several areas of potential concern. Given firms' upbeat predictions for the coming quarter, significant uncertainty about demand constraining business expansion over the year ahead is of particular interest. This implies that any recovery in business could prove to be fragile, and might easily be reversed by economic or political shocks. Predictably, regulation remains the industry's other major preoccupation; it is seen as a significant barrier to growth, and as a leading driver of investment and spending.

Figure 3: Trends in overall profitability



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

Figure 4: Trends in numbers employed



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

The banks' growing confidence may owe something to the recent stabilisation in UK economic forecasts.

Banking

The banks are feeling much more confident, reflecting stronger profitability and positive forecasts for revenue. However, steep job reductions are having a negative effect on their capabilities. The sector is also facing growing challenges over capital.

The banks report a dramatic return to optimism, with the highest balance of respondents since 2004 feeling more confident than three months ago. Although very welcome, this swing in sentiment is hard to credit in the light of the banks' other responses. True, revenues are expected to increase during the first quarter of 2013, and marketing plans have received a strong boost. But the banks have made similar forecasts before, only to be disappointed. Commercial business in particular failed to live up to its promise, declining during the last months of 2012.

The banks' growing confidence may owe something to the recent stabilisation in UK economic forecasts. It is notable, for example, that the value of non-performing loans is reported to have stabilised. Even so, there are indications that this new-found confidence could prove fragile. The banks take a negative view of business across all customer segments, and for the third quarter running, nearly all those surveyed identify weak demand as a likely obstacle to growth.

Another sign that the banks may not be feeling as confident as they appear comes from a renewed focus on costs. Nearly all respondents report lower levels of headcount, with further reductions in the pipeline. Tight cost control is supporting profitability, but there is clear evidence that job cuts are creating problems. A striking number of banks see a shortage of managerial talent as limiting their ability to invest effectively in the year ahead, particularly in the compliance arena. A lack of skilled staff is also seen as a fast-growing barrier to development.

The banks are not just facing a shortage of skills. The survey suggests that the sector may also be facing a growing capital challenge. The UK banking sector is well capitalised by European standards, and for most of 2012 banks were not expecting to raise fresh capital. However, increasing balance sheet scrutiny from regulators and investors is bringing a new dimension to the debate. The banks now expect the ability to raise finance to be a significant limitation on business during 2013. This implies that their upbeat predictions for growth could be undermined by an inability to commit sufficient capital to lending.

Building societies

Building societies' confidence has stabilised, with the sector enjoying the effects of Funding for Lending on average spreads. Lower levels of impairments are also supporting profitability, but there are suggestions that the sector's upbeat forecasts could prove to be fragile.

After two quarters of falling confidence, building societies' sentiment has stabilised.

After two quarters of falling confidence, building societies' sentiment has stabilised. In one sense, anything else would have been surprising. After all, interest rates, house prices, arrears and other key features of the sector's operating environment remain virtually static.

Even so, the survey results contain several positive findings. Perhaps the most notable is that – as predicted in our last bulletin – the Bank of England's Funding for Lending scheme appears to be relieving pressure on societies' margins. Although competition in the mortgage market remains intense, many societies are taking advantage of this cheap funding to broaden their spreads. Profitability also receives a boost from a reduction in non-performing loans, the first reported by the societies for over a year. This is another welcome finding, and it is encouraging that a majority of those surveyed expect to see a further fall in impairments during the first quarter of 2013.

The societies are increasingly upbeat about their business outlook. Volumes and revenues are expected to increase over the coming quarter, and predictions for retail business are at their most buoyant for a decade. Stronger marketing spending and unanimous plans to acquire new customers strongly suggest that the sector is getting ready to increase lending. These views are supported by chartered surveyors' forecasts of higher home sales in 2013.[2] Societies' increasing willingness to lend is underlined by the growing expectation of competition from within the sector.

Despite these encouraging results, the societies are not entirely upbeat about the year ahead. Regulation has rebounded as a concern, and is seen as the greatest obstacle to business development. The survey also hints at a potential shortage of specialist compliance staff, as the sector struggles to meet the demands of 'twin peaks' at a time of cutbacks. Lastly, growing concern about the strength of demand suggests that the sector's confident forecasts could easily be revised downwards.

2 'RICS housing market forecast 2013', Royal Institute of Chartered Surveyors, 14.12.12.

General insurance

General insurers are feeling slightly more confident, and are hoping for stronger rates through the commercial renewal season. Even so, weak investment returns remain a major challenge and profitability is under pressure. There is growing interest in forming strategic partnerships.

General insurers are feeling slightly more confident for the first time since March, in response to an unexpectedly strong quarter for volumes of business and premium income. Respondents predict further growth in premiums for the first quarter of 2013, implying that rates may harden slightly through the commercial renewal season. In part, this may reflect the effect of Hurricane Sandy, which promises to be a major loss event for wholesale and reinsurers. In contrast, the autumn's UK floods, although a major news story, affected comparatively few people and are unlikely to have much effect on retail pricing.

Unlike premium income, the value of investment income continues to fall. The weak investment component of many insurers' returns continues to have a disproportionate impact on combined ratios, and is increasing the industry's focus on underwriting profitability. With this in mind, it is disappointing that the claims environment remains challenging. Apart from a one-off decline in June, insurers' focus on fraudulent claims and the proposed tightening of the law on referral fees have not managed to stem the rising tide of claims during 2012.

The combined effect of low investment returns and higher claims has been to keep profitability under pressure for much of the year. Encouragingly though, and despite predicting that claims will continue to climb, respondents expect a favourable round of renewals to boost their overall profitability during the first quarter of the New Year.

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General insurers' plans for the year ahead are focused on retaining their existing customers and, above all, acquiring new ones. It is interesting to note that, even though M&A remains the subject of considerable debate within the industry, those surveyed do not expect to see a pick-up in deal activity during 2013. Instead they predict growing interest in strategic partnerships. Distribution alliances are likely to be a particular area of focus, as insurers face a potential shake-up in their established routes to market from the Financial Conduct Authority. Despite this prospect, overall concern about regulation has fallen, reflecting the delay in Solvency II implementation.

Life insurance

Life insurers report a positive set of results, buoyed by a strong performance in the run up to retail distribution review (RDR) implementation. The sector continues to invest for the future by developing its IT platforms, and the delay in Solvency II brings a temporary respite from regulatory concerns.

Life insurers report a huge upswing in sentiment. Coming after the last survey's reported decline, this represents the sector's most confident response in more than three years. Life insurers' mood has apparently been boosted by a strong quarter for business, not to mention a marked and very welcome reported increase in profitability. The sense of optimism may also reflect more intangible factors, such as relief at the delay of Solvency II.

Pre-Budget rumours about changes to the treatment of pension contributions may also have given new business a boost.

Most respondents see revenues and volumes of business as having increased during the last quarter of the year. As highlighted in recent editions of this bulletin, life companies and IFAs have been focusing on maximising sales before the introduction of RDR reforms in January 2013. Pre-Budget rumours about changes to the treatment of pension contributions may also have given new business a boost. However, this picture of growth is expected to stabilise in the first quarter of 2013. This suggests that though life companies may be feeling broadly optimistic, they remain unsure about the short-term impact of the end of commissions.

The effects of regulatory change can also be seen in life insurers' plans for capital expenditure. Investment in IT continues to grow, as the sector focuses on implementing Solvency II and on building efficient, high-capacity platforms fit for a post-RDR world. The requirements of regulation, and the difficulty of attracting and retaining top quality compliance talent, mean that a shortage of professional staff is seen as a rapidly growing threat.

The fact that almost all those surveyed report higher total costs and levels of employment is harder to explain. Recent public announcements by life insurers have stressed the industry's commitment to cost control. In contrast, higher reported levels of staff turnover ring true. Anecdotal evidence suggests that staff mobility in the industry is high.

Securities trading

Securities traders remain by far the most downbeat respondents to the survey. There are some hopes for improvement, but most forecasts remain clearly negative. If there are grounds for encouragement, they come from an anticipated stabilisation in levels of employment.

Where firms are still investing, the focus is firmly on compliance and efficiency.

Securities traders are the only major sub-sector of financial services to report continuing falls in sentiment about their overall business situation. Confidence has fallen even more rapidly than at the last survey. Although disappointing, this is hardly surprising. Almost all of the sector's key responses – including volumes of business, revenues and overall profitability – are still on a downward track.

A closer look through the survey results reveals some mildly encouraging findings. For example, forecasts for volumes of business during the first quarter of 2013 are only slightly negative. And for the first time this year, a small balance of respondents now expects fee income to rise. Given the comparative stability of European financial markets during the final months of 2012, this may indicate hope for slightly stronger capital issuance during the opening months of the New Year. But these are slim pickings. Predictions for business activity are negative across most customer segments, and weak demand is identified as the greatest obstacle to growth.

Uncertain demand is also seen as the leading barrier to capital investment. In the current environment, securities traders are finding it hard to identify areas to allocate capital with the realistic hope of generating a return. Where firms are still investing, the focus is firmly on compliance and efficiency. And although marketing plans have received a boost, this has a strong defensive focus. Firms say that customer retention is their greatest priority for the year ahead.

Perhaps the most encouraging news to emerge from the survey is that the reductions in operating costs that have been a feature of 2012 may have hit bottom. A small balance of respondents expects costs to increase during the coming quarter, and there are signs that staff reductions are coming to an end. Even so, there may be seasonal factors at work. Securities houses typically find it easiest to employ new staff in the first quarter, giving job prospects a boost at this time of year.

A majority say they employed more staff during the last quarter and predict further increases in the New Year.

Investment management

Investment managers remain remarkably optimistic. Overseas business is growing, but it will be interesting to see if predicted retail growth will materialise. Regulatory uncertainty is exceptionally high, but the sector continues to add headcount.

Investment managers continue to experience growing optimism, and report another remarkably positive set of responses. Business volumes, revenues and profitability remain firmly on an upward track. This growth appears to be coming from a variety of sources. Commercial business has grown but is now expected to level off, while business with financial institutions has stabilised after expanding in September. In contrast, overseas activity is on the rise. This is welcome news for the many firms that have committed time and resources to developing their international business.

It is also notable that overseas expansion is now a leading theme of respondents' growth plans for the year ahead.

Closer to home, it is interesting to see a modest prediction for retail growth in the first months of 2013 – traditionally the strongest quarter for net retail sales. In the current environment of economic uncertainty, but comparatively stable financial markets, it will be interesting to see if retail sales can improve on 2012's disappointing figures.[3] The first quarter of 2013 could be crucial if the sector is to justify the strong optimism that has been its hallmark throughout 2012.

That optimism is evident from respondents' recruitment plans. A majority say they employed more staff during the last quarter and predict further increases in the New Year. This suggests that investment managers may be taking up some of the slack in the financial job market, although in most cases the actual increase in numbers employed is likely to be small.

Regulation is one of the few areas where investment managers admit to feeling less optimistic. It is seen as a barrier to growth by 91% of respondents, a striking response and the highest such figure in more than twenty years of survey data. The sector also faces a particularly high level of uncertainty over the impact of new regulations. The final implementation of the alternative investment fund managers directive (AIFMD) remains frustratingly unclear, firms are waiting to see how the RDR reforms will affect their business, and the sector faces a range of emerging initiatives such as the EU's proposals on shadow banking. All in all, it is no surprise that regulatory spending is expected to continue rising.

3 *Retail fund sales, Q4 2010 – Q3 2012*, Investment Management Association website.

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Copies of the full survey are available from the Confederation of British Industry, tel: 020 7395 8270, 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 19 November and 6 December 2012. A total of 94 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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