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Industry sentiment

Financial Services Survey

CBI/PwC quarterly survey measuring trends and providing insight from the industry
Issue number 95
June 2013

pwc

The 95th CBI/PwC Financial Services Survey shows that the industry's recovery is gaining momentum.

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Executive summary

The 95th CBI/PwC financial services survey shows that confidence is continuing to build across most areas of the industry. This is supported by a further improvement in volumes of business, and upbeat assessments of customer demand. There are considerable variations in the financial performance between sub-sectors, but the overall trend in profitability is clearly to the upside. Recruitment and investment plans show signs of an increasing focus on customer acquisition and other sources of growth.

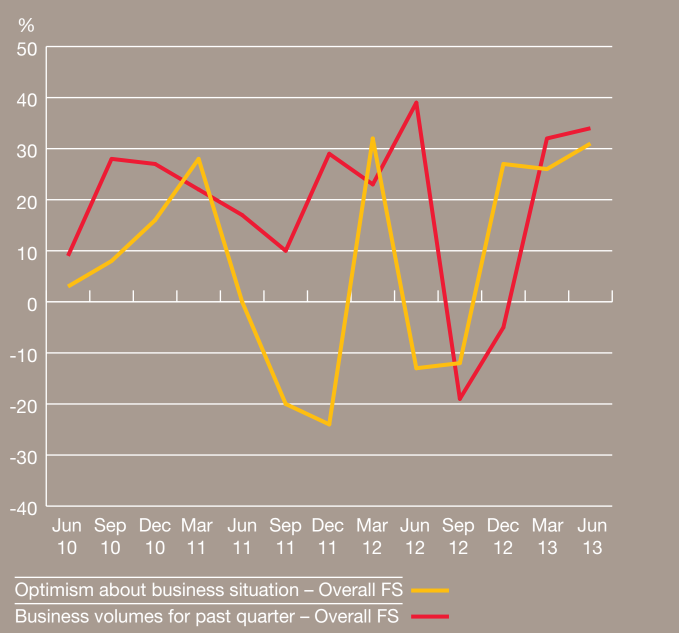
The recovery in financial services sentiment is gaining momentum

UK financial services firms are enjoying their third consecutive quarter of improving sentiment. The industry's growing confidence is supported by a second quarter of strong rise in volumes of business (see Figure 1). It is also notable that aggregate forecasts for volume growth have reached their highest level for three years. These very positive responses suggest that, barring any external economic shocks, the recovery in financial services sentiment that began at the end of 2012 will be sustained for the remainder of the year.

The improvement in overall confidence over the past six months has coincided with the stabilisation, and then the marginal improvement, in forecasts for UK economic growth.[1] Several findings from the current survey support the impression of an improving economic outlook. One is a further increase in aggregate levels of activity across both the commercial and the retail segments. Another is a third consecutive fall – albeit a modest one – in the value of non-performing loans.

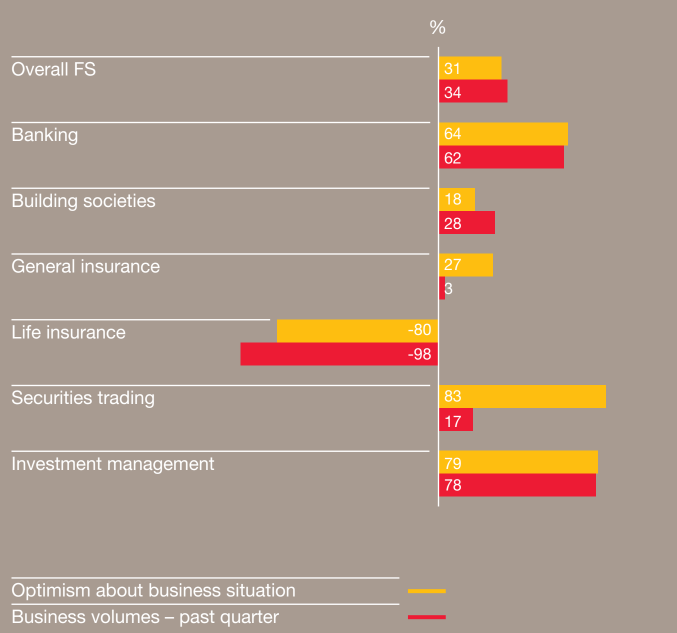
1 *Comparison of independent forecasts – June 2013,* HM Treasury, 19.06.13.

Figure 1: Optimism and business volumes



Source: CBI/PwC Financial Services Survey, June 2013.

Figure 2: Optimism and business volumes by sector



Source: CBI/PwC Financial Services Survey, June 2013.

Most sectors of the industry report some improvements – life insurance is the exception

Another encouraging aspect of the latest survey results is that the improvement in confidence is being felt in most corners of financial services. Apart from life insurers, the major sub-sectors of the industry are all feeling optimistic about their business situation. In most cases, this is closely matched by improved volumes of business (see Figure 2).

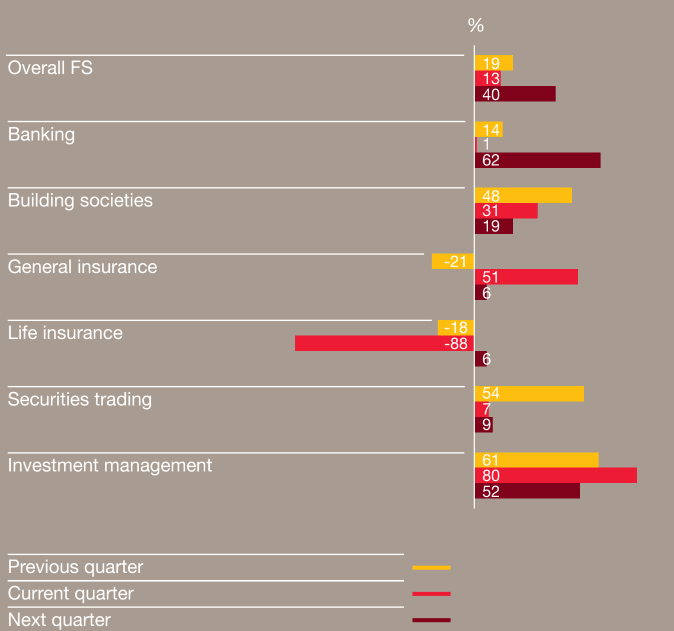
Even so, different sectors of the industry are facing very different dynamics. Banks and investment managers are the most upbeat, while building societies are cautiously positive. Securities traders are feeling more confident but face challenges over growth, and life insurers expectations for business and profits growth are more tempered. These variations are even more visible in respondents' assessments of profitability. The past three quarters show that overall profitability has been sustained, but this conceals a considerable range of responses (see Figure 3).

Cost control and regulation remain priorities, but there is an increasing focus on growth

Improvements in profitability are not just down to stronger levels of business. Total operating costs are declining, and this is expected to support profitability growth over the summer. Numbers employed are reported to have declined during the quarter, but a modest recovery is predicted over the summer months. Supplementary questions show that drivers of recruitment vary considerably between sub-sectors. For investment managers, entering new markets is the leading motivation for hiring; among insurers, a change of strategy is seen as more important. Banks' and building societies' hiring plans are largely shaped by the requirements of regulation. Across the industry as a whole, regulation also remains the strongest driver of capital expenditure.

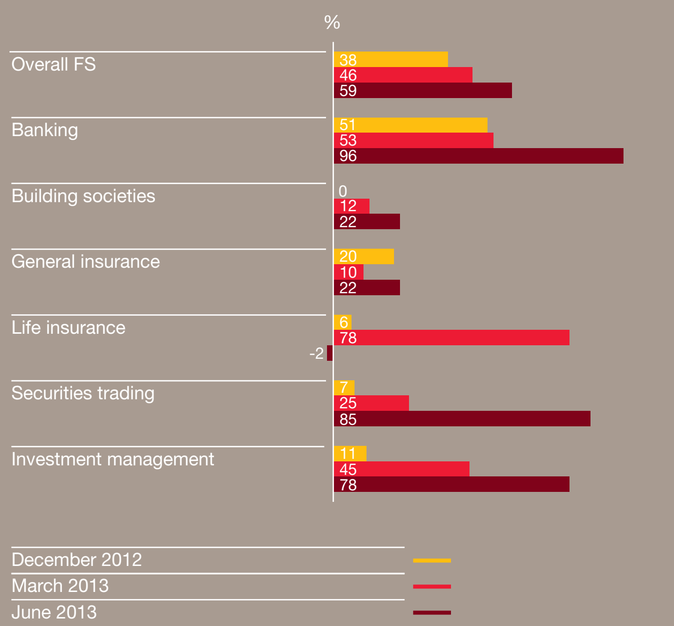
In response to lingering concerns over the strength of demand, several sectors identify customer acquisition as a priority for the year ahead. Supporting this, investment in IT is seen as increasingly important to achieving growth (see Figure 4). This reflects a range of goals, including the need to manage and make the most of customer data.

Figure 3: Trends in profitability



Source: CBI/PwC Financial Services Survey, June 2013.

Figure 4: Importance of IT investment as an enabler of growth



Source: CBI/PwC Financial Services Survey, June 2013.

Banking

Banks are growing increasingly confident, buoyed by improving results and growing customer activity. Costs remain controlled, and non-performing loans are expected to decline over the summer. Respondents are wary of the threats posed by regulation and, potentially, new entrants.

Banking confidence continues to grow, increasing at the fastest rate since 2000.

Banking confidence continues to grow, increasing at the fastest rate since 2000. The banks' upbeat mood is supported by a very positive set of results, including a strong reported rise in volumes of business. Average spreads tightened during the quarter, but net interest income grew. This was matched by non-interest income, as banks turned to fees to boost their revenues.

These bullish responses are backed up by strong activity with both commercial and retail customers. This may not mean that credit appetite is growing, but it certainly implies an improvement in economic confidence. Commercial business is seen as following a particularly positive trend, moving from a balance statistic of -44% in December 2012 to +16% in March and +61% in the current survey.

After allowing costs to rise in the first quarter of the year, banks are renewing their focus on efficiency. Staff numbers have also begun to fall again. This may not be good news for employees, but shareholders will be pleased that a majority of respondents expect profitability to improve over the summer. Retail and commercial non-performing loans are also predicted to decline during the coming quarter. This not only implies that housing arrears will remain controlled, but also that the banks may have been justified in showing forbearance to some commercial borrowers.

The survey sounds a few notes of caution. Despite making plans for customer acquisition and product development, the banks retain doubts about the sustainability of demand. They also see new entrants as a growing threat. This reflects the anticipated spin-offs by RBS and Lloyds, and perhaps the Prudential Regulatory Authority's plans to relax capital and liquidity rules for new banks.[2] Regulation remains a widespread concern, and the leading driver of capital expenditure. A supplementary question shows that the banks see regulation as a more important driver of recruitment than any other sector.

2 *'Capital rules relaxed for new UK banks'* Financial Times, 26.03.13.

The survey shows a picture of steadily increasing business and revenues.

Building societies

Building societies continue their run of optimism, and are increasing their lending appetite. They are also enjoying strong profitability growth – a remarkable turnaround from the early years of the crisis. Investment is growing, but the sector remains concerned about regulation and long-term demand.

Building societies report a third consecutive quarter of rising confidence – something that few would have believed possible two years ago. The survey shows a picture of steadily increasing business and revenues. The societies' increasing willingness to lend is evident from their strong marketing plans. The sector as a whole is now expanding its net mortgage market share at the expense of the banks.[3]

The societies' strong liquidity position reflects the continuing impact of the Funding for Lending Scheme (FLS). The FLS has had the effect of reducing competition from the banks for retail deposits – allowing societies to reduce their savings rates while maintaining funding levels. The significance of this change is underlined by the societies' relaxed assessment of competition from other sectors – a marked reversal from a year ago.

The financial effect of FLS is equally stark. A balance statistic of +95% say that average spreads have widened, and all those surveyed report stronger net interest income. Together with a modest increase in fees, this has offset the effect of higher costs and delivered the societies' third successive quarter of improved profitability. Non-performing loans have grown, but this reflects some societies' legacy exposures to commercial real estate. Arrears in the all-important retail segment are reported to have fallen.

Encouraged by stronger forecasts for the housing market,[4] some societies are increasing their volumes of more specialised mortgages, such as higher loan-to-value and first time buyer products. These more complex products, together with the growing volume of vanilla lending, are putting pressure on underwriters and application processes. In response the societies are planning to make greater use of IT, not only to increase automation but also to improve the quality of online service offerings. Regulation is the sector's greatest worry, and is seen as the leading limitation on business and a major driver of higher costs. Supplementary questions show that the societies are the only sector apart from the banks to identify regulation as their leading driver of recruitment.

3 *'UK Building societies target first time buyers'*, Financial Times, 10.05.13.

4 *'House prices top pre-credit crunch high'*, Financial Times, 14.06.13.

General insurance

General insurers report a solid and welcome improvement in confidence. Revenue growth remains hard to achieve, but profitability has received a boost from cost reductions and lower claims. Faced with a weak outlook for demand, insurers are investing in their ability to harness customer data.

General insurers' responses may be a mixed bag, but they represent a distinct improvement on those of recent surveys. Above all, the sector is enjoying its strongest growth in headline optimism for two years – a marked turnaround from the previous quarter. As hoped, insurers have seen a welcome pickup in corporate business. And although retail activity has remained steady, there are growing hopes that it will accelerate as the economy recovers.

Despite these encouraging responses, there is no denying the sector's challenging revenue environment. Premium income has failed to meet expectations, suggesting that pricing remains under pressure. Investment income has also fallen for the fifth quarter in a row, reflecting the effects of exceptionally low bond yields.

Considering this picture of slow revenue growth, it is surprising that the survey shows the strongest reported increase in profitability since 2008. One important factor is a fall in the value of claims, an unexpected but welcome finding. Expectations of a further decline over the summer suggest that the industry's investment in claims management may finally be paying off. The improvement in profitability was also supported by reductions in headcount and total operating costs. It is encouraging to see the industry focusing on efficiency, but this is a reminder of the role that cost management plays in many insurers' ability to deliver earnings growth.

One important factor is a fall in the value of claims, an unexpected but welcome finding.

General insurers view regulation as a lesser threat than any of the other key sectors covered by the survey, probably owing to their relatively predictable compliance outlook. In contrast, demand remains the sector's overwhelming concern. In response, the need to reach new customers is identified as a major driver of investment. The importance of cross-sales to respondents' growth plans is underlined by insurers' interest in the effective, intelligent use of customer data.

Life insurance

Life insurers are feeling much more pessimistic, with business continuing to contract in the wake of the Retail Distribution Review's (RDR) implementation. Revenue and profitability are coming under intense pressure. In response, firms are trying to adapt their distribution strategies to their new environment.

Life insurers' headline confidence has fallen dramatically since March, making them the most downbeat of any of the major sectors covered by the survey.

Overall, their responses paint a picture of a sector struggling to adjust to its new distribution environment. Volumes of business are reported to have fallen by a balance statistic of -95%, more than meeting March's gloomy predictions. This further decline in activity is not expected to be reversed entirely over the summer, raising the possibility that the post-RDR slump will last all year. That impression is reinforced by an extremely negative assessment of retail activity. Furthermore, corporate pension business has failed to take up the slack, as had been hoped.

The impact of weak demand on revenues is proving to be severe. Almost all those surveyed report lower premiums and weaker levels of new business. Combine this with downward pressure on investment returns and renewed growth in operating costs, and it is no surprise that profitability is seen as having reached its lowest point in four years.

Life insurers expect the year ahead to throw up an exceptional range of obstacles. Apart from weak demand, firms are seriously concerned about competition, skills shortages, inadequate systems and the availability of capital. Regulation also remains a major challenge. The sector's expectations that compliance costs will fall over the coming year could yet be trumped by the Financial Conduct Authority's (FCA) thematic reviews, or by Solvency II returning to the agenda.

In their search for growth, life companies are placing renewed emphasis on customer acquisition. Capital is being committed to a range of IT projects, and respondents see investment in sales, distribution and marketing software as particularly important for future growth. It is notable that the sector's focus on domestic expansion is accompanied by an increasing appetite for mergers and acquisitions (M&A). This finding suggests potential for significant changes to the industry's structure in the UK.

In their search for growth, life companies are placing renewed emphasis on customer acquisition.

Securities traders continue the rapid improvement in sentiment that began in March.

Securities trading

Securities traders continue to feel more confident, but their financial performance seems to be stuck in a low gear. The sector remains concerned about its prospects for long-term growth, but headcount has increased and plans for customer acquisition are afoot.

Securities traders continue the rapid improvement in sentiment that began in March. On that occasion, increasing confidence was matched by a positive set of survey responses. This time around, the sector's optimism is harder to understand. Volumes of business and fee income rose only modestly during the quarter and growth in activity with retail, commercial, financial and overseas customers remains anaemic at best. Respondents' forecasts for the coming quarter are also largely neutral. Volumes of business and income are expected to either fall or remain stable over the summer.

At face value, these underwhelming responses do not appear to explain traders' buoyant sentiment. After the stress and volatility of recent years, perhaps the comparative stability of financial markets during the first half of 2013 has been enough to lift the sector's mood.

Looking ahead, securities traders have deep-seated concerns over the effect of weak demand. Marketing expenditure is expected to level off, and the sector's investment plans are modest. A sharp increase in the perceived challenges of competition also suggests overcapacity in the market. Even so, those surveyed see cross-selling and customer acquisition as vital to achieving stronger growth. Given that new strategies are identified as the leading driver of recruitment, it is encouraging to see that staff numbers have grown. A prediction that staff turnover will increase during the next quarter is more unexpected. The summer months are typically a quiet period for personnel changes in the securities industry.

Surprisingly, regulation is seen as a much lesser threat than in recent quarters. Considering the sector's considerable compliance burden, this may reflect a lull in new regulatory announcements. Supplementary questions show that respondents view the possibility of a European Financial Transactions Tax with serious misgivings. In contrast, traders are oddly untroubled by the EU's proposed bonus cap, given its potential to limit cost flexibility.

Investment management

Investment managers enjoy a further improvement in sentiment, buoyed by strong improvement in revenues and profitability. Respondents are adding staff and investing in data management to support their aims of international expansion.

The desire to enter new markets is the leading driver of recruitment, and improvements to IT are identified as an important enabler of growth.

Investment managers report a further improvement in optimism, supported by another quarter of firmly positive survey responses. Firms continue to benefit from the comparative stability of financial markets, not to mention the year-long recovery in equity values. Volumes of business and fee income are both reported to have grown by a balance statistic of +53%, and activity continues to improve across every customer segment. The sector's profitability has increased for the sixth consecutive quarter.

Encouraged by this, investment managers continue to allow operating costs to climb, although the pace of growth appears to have slowed. Higher levels of staffing are a major factor. The reported increase in numbers employed is the highest since 2010, and all those surveyed expect further growth in headcount over the summer.

The sector's confidence is reflected in its assessment of the year ahead. Concern over the strength of customer demand has reached its lowest level in more than two years, and the requirements of growing activity are the leading driver of recruitment. Marketing spend in the year ahead is also expected to increase by almost all respondents, relative to the past twelve months. As a result, investment managers are pushing hard to acquire new customers at home and abroad. International expansion remains a particularly important goal. The desire to enter new markets is the leading driver of recruitment, and improvements to IT are identified as an important enabler of growth. This is closely linked to the need for better management of customer data – both to satisfy regulatory requirements such as FATCA and Form PF, and for use in cross-selling and business development.

Despite the gradually improving clarity around supervisory changes, regulation is identified as the single greatest obstacle to the sector's growth. The proposed EU bonus cap is of particular concern. Investment managers expect the proposal to make staffing costs less flexible, as well as increasing the difficulties of talent retention.

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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 20 May and 6 June 2013. 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).

The Design Group 21373 (06/13)

Printed on paper manufactured in the EU containing recycled fibre.

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