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Industry sentiment

Financial Services Survey

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

Issue number 92
September 2012

pwc

The 92nd CBI/PwC financial services survey shows a further decline in sentiment, and a fall in overall volumes of business.

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Executive summary

The 92nd CBI/PwC financial services survey shows a further decline in sentiment, accompanied by the first overall fall in volumes of business since 2009. Economic uncertainty in the UK and across Europe is overshadowing the industry, but it is encouraging to see that commercial business is holding up well. Costs and employment remain under control, but pressure on profitability implies that firms need to find greater savings. Unfortunately the rising tide of regulatory cost is making that goal difficult to achieve.

Confidence falls again, and business volumes decline for the first time since 2009

The confidence of UK financial services firms continues to decline, leaving March's improvement in sentiment far behind (see Figure 1). Apart from investment management, all the major sub-sectors of financial services are feeling less confident about their business situation.

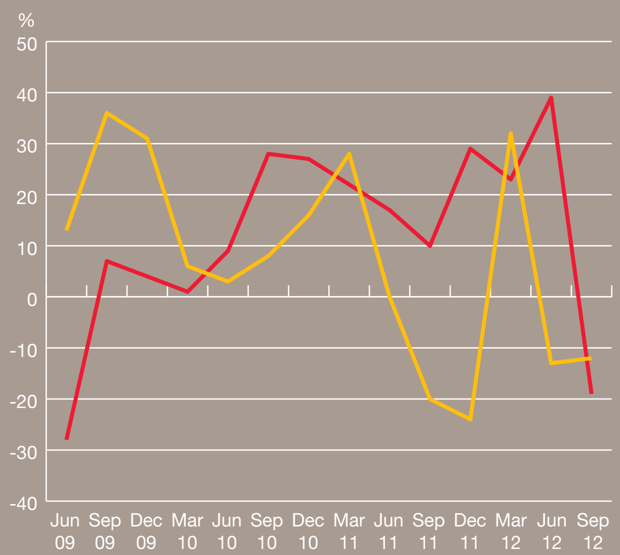
It is not just confidence that has fallen. Aggregate volumes of business are reported to have declined for the first time in three years (see Figure 1).

This is significant, given that volumes of business have held up better than might have been expected until now. Even so, it is worth noting that business is predicted to grow again before the year end. It is also notable that the declines in business reported by banks, general insurers and securities traders are offset by rising volumes among building societies, life insurers and investment managers.

Economic uncertainty is hurting demand and investment – but is there light ahead?

There is no doubt that the UK's lacklustre economic performance is hanging heavily over the industry. Consensus forecasts for GDP growth in 2012 have been revised down from +0.3% to -0.3% in just three months.[1]

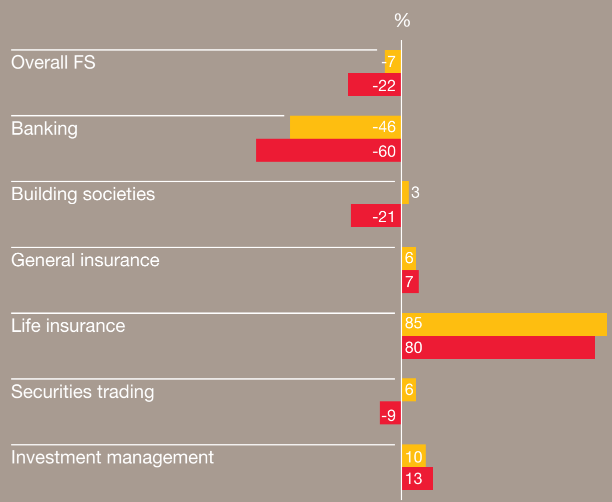
Figure 1: Optimism and business volumes



Optimism about business situation – Overall FS
Business volumes for past quarter – Overall FS

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

Figure 2: Trends in numbers employed



Previous quarter
Current quarter

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

The survey shows that uncertainty over demand is seen as the leading limitation on future growth, and by far the largest barrier to capital investment. This is not just about the UK, but also the wider European picture. Political and economic uncertainty in the eurozone, which has a disproportionate impact on financial services, is encouraging firms to delay investment decisions until absolutely necessary.

In the context of a slowing economy, it is encouraging that the survey shows financial firms' business with industrial and commercial customers holding up strongly. It is particularly welcome to see that the banks are doing more business with the commercial sector.

This suggests that initiatives such as the Bank of England's Funding for Lending programme may be having some effect, even if it is too soon to fully judge their impact. Building societies are also planning to take advantage of the scheme to boost their mortgage lending.

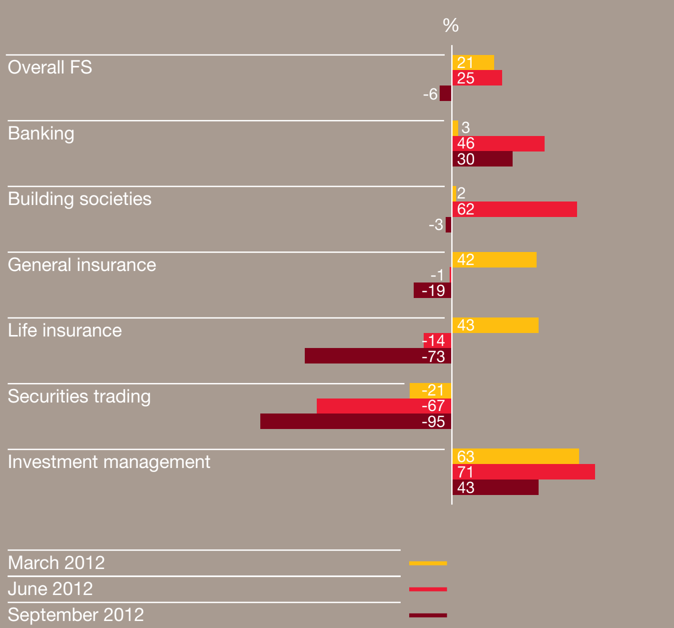
Profitability is under intense pressure, suggesting that firms need to do more to reduce costs

Faced with such weak demand, the industry is continuing to take steps to reduce its cost base. Several sectors – including, most strikingly, the banks – report lower levels of headcount (see Figure 2). Overall expenses remain fairly well controlled, but it is hard to avoid the conclusion that much more needs to be done to put costs onto a sustainable footing. Business models are coming under growing pressure and every major sub-sector reports lower or slowing profitability (see Figure 3).

Unfortunately, reducing costs is challenging at a time when the burden of regulation is growing faster than at any time in recent memory. Three quarters of all those surveyed expect to increase their compliance spending over the coming year, and regulation is the leading driver of capital expenditure in several sub-sectors (see Figure 4). Regulation has also become the second greatest obstacle to growth, ahead of competition and exceeded only by the effects of weak demand.

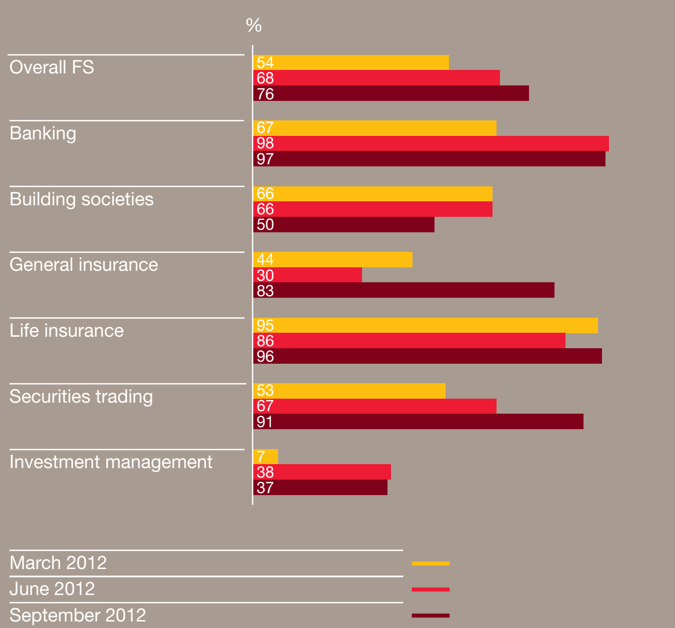
1 'Forecasts for the UK economy', HM Treasury, June 2012 and September 2012.

Figure 3: Trends in overall profitability



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

Figure 4: Regulation as a driver of investment



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

It is encouraging that a majority of respondents expect commercial business to grow again during the coming quarter.

Banking

The banks are putting their efforts into increasing commercial lending, but report lower overall volumes of business. A majority have reduced their headcount, with further cuts to come. The outlook is dominated by concern about weak demand and the growing costs of regulation.

The banks report a second quarter of stable sentiment, but this glosses over some interesting findings that illustrate the challenges facing the sector. One notable result is that commercial business is growing again after stalling at the last survey. This reflects the banks' growing efforts to meet social and economic expectations by increasing their lending to businesses. This is not straightforward, since weak demand for credit is as much an issue as weak supply. One solution is to ease lending criteria, but the banks are wary of accusations of irresponsible lending. They also face a paradox: the weakening economy is pushing up credit risk, but over-cautious lending threatens to make the situation worse. So it is encouraging that a majority of respondents expect commercial business to grow again during the coming quarter.

It is a different story in the retail arena. Here, the growth that had been a welcome feature of recent surveys has come to a halt, as the banks focus more on commercial than consumer lending. Although impairments remain modest in absolute terms, growing retail non-performing loans underline the strain on household finances.

The contrast between commercial and retail activity is affecting the banks' overall performance. Volumes of business have declined for the first time in a year, prompting the majority of banks to reduce their headcount. Further cuts in jobs and overall costs are predicted. This, combined with expanding spreads, is supporting profitability.

The sector's outlook is dominated by two concerns. The first is weak demand, seen as the greatest threat to growth and the leading barrier to investment. The second is regulation. The flow of initiatives from the FSA, Westminster and the EU is a growing limitation on business, and a major source of capital and operating expense. Competition is also a growing worry, as many banks exit more capital-intensive activities and focus on the same low-risk businesses.

Building societies

Building societies are successfully growing their businesses. Encouraged by the Bank of England's Funding for Lending scheme they are setting more upbeat targets, but this is expected to lead to tougher competition. The societies remain concerned about life in a world of tighter regulation.

Building societies' sentiment is falling, but at a much slower rate than in June when almost all respondents were feeling pessimistic. The Bank of England's announcement of Funding for Lending has had a perceptible impact on the sector's mood, and some societies are feeling slightly more positive about the outlook for their business. Most have yet to make use of the scheme, but many are planning to do so. It represents a welcome opportunity for the societies to get around the challenges of deposit and wholesale funding and begin to slowly grow their balance sheets.

Even though the tangible impact of Funding for Lending is still limited, the societies report an increase in business. Growth in overall volumes and in business with private individuals are the strongest reported by the survey since 2010, and further improvements are forecast. Despite the sluggish housing market the societies are competing for mortgage business, aiming to capitalise on public scepticism towards the banks.

Several responses suggest that building societies are meeting their relatively modest lending targets. Customer acquisition and market share gains are identified as the leading drivers of future growth, and all those surveyed are expecting to see more competition from their peers in future. This is a significant shift. Over recent quarters the societies have consistently shown much more concern about the effects of competition from the banks.

Regulation remains the sector's greatest source of uncertainty. There is a realisation among societies that the current growth in regulation is unlikely to be reversed – notwithstanding July's Treasury consultation paper on the future of building societies – and that regulators will take an increasing interest in areas such as product development. These concerns, together with continuing pressure on spreads and profitability, are encouraging the societies to keep their operating costs under control. If Funding for Lending does relieve some of the pressure on societies' margins, it could allow the sector to commit more capital to marketing, product development or infrastructure improvements.

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General insurance

General insurers are facing a decline in demand across many of their activities, reflecting the weakening economic situation. The sector's profitability is also under pressure. In response, new strategic alliances are emerging and reinsurers are using insurance-linked securities for capital flexibility and risk sharing.

The only silver lining comes from commercial lines, which have seen an unexpected improvement.

General insurance sentiment is falling less rapidly than before, but remains the most downbeat of any major sub-sector. Volumes of business and premiums have declined again, confounding hopes of a recovery and reflecting the economic slowdown. Business with private individuals is falling as customers cut back on discretionary cover such as travel. The negative publicity around payment protection insurance may also be affecting demand. Meanwhile, a decline in financial business mirrors the slowdown in capital markets activity. The only silver lining comes from commercial lines, which have seen an unexpected improvement.

Weak demand is not just a feature of current performance. It hangs over insurers' forecasts for the rest of 2012, and is expected to be the leading limitation on business over the year ahead. Uncertainty is seen as a barrier to investment by 91% of insurers, the highest figure for six years.

Falling premiums and weak investment income are hurting insurers' financial performance. Overall costs remain steady, but costs per transaction are rising and profitability is falling. Respondents also report a fresh increase in claims, the result of the early summer's widespread flooding. Faced with slow growth, falling profitability and reduction in their coverage of gross losses, some reinsurers are using insurance-linked securities to provide more capacity. These products are structured to offer a range of returns to institutional investors, depending on their risk appetite. The packaging of direct insurance risk without attached investment risk or other risk portfolio effects is appealing to some institutions, although it requires specialist understanding.

Looking ahead, insurers show growing interest in forming strategic partnerships. For some this reflects a desire to spread risk and improve reserve modelling. Many insurers struggled with elements of their loss profiles in 2011, such as the disruption of global supply chains by natural disasters. Reinsurers are also developing new distribution partnerships as they seek to expand in faster growing markets. Lastly, regulation – and the secondary effects of Solvency II in particular – is identified as a greater obstacle to growth than at any time since 2005.

Life insurers are working to adapt their platforms and products in anticipation of the coming changes.

Life insurance

Life insurance is booming, as firms chase business before the introduction of the Retail Distribution Review (RDR). Even so, margins and profitability remain under pressure, and this is only likely to increase. Life insurers are working to adapt their platforms and products in anticipation of the coming changes.

Sentiment in the life insurance sector has declined slightly, but has changed little overall during 2012. This comparatively stable picture gives little hint that the life insurance industry is fast approaching a major turning point – the introduction of the RDR.

Life insurers' steady headline sentiment also contrasts with their top-line performance. A balance statistic of +81% report stronger volumes of business, and further growth is anticipated in the coming quarter. The approach of the RDR is encouraging life companies and independent financial advisers (IFAs) to book as much business as they can before the year end. Despite this growth, however, the total value of premiums is reported to have stalled. True, premiums are expected to recover during the coming quarter, but margin pressure is a growing feature of the life insurance market. This is a theme that is only likely to become more dominant after January 2013.

Given the pressure on premiums, it seems odd for life insurers to report another strong quarter for new business. This may be explained by the continuing strength of commercial activity. Corporate pension business generates good long-term returns, pushing up embedded value even when margins are falling elsewhere.

Even so, the margin squeeze – combined with a further fall in investment income – is putting profitability under pressure. Regulation is also having an effect. The requirements of Solvency II and the RDR are pushing up headcount, and the continuing shortage of actuarial talent is further inflating staff costs. A balance statistic of +96% of respondents report higher total costs, the strongest figure in more than 20 years of survey data.

There are encouraging signs that life companies are preparing for life in a post-RDR world. Investment in IT continues to grow as firms seek to build scalable, efficient platforms as a basis for competition in a dramatically altered landscape. Innovation is also on the rise, as insurers work to develop simpler, more transparent products with lower management charges.

Securities trading

Securities traders make an extremely downbeat assessment of their business prospects. Revenues are falling fast, and the rising costs of regulation are putting profitability under further pressure. This points to overcapacity in some sections of the markets, stimulating growing interest in the possibilities of M&A and other strategic alliances.

Securities traders report another decline in sentiment, with the sector facing challenging business conditions and an uncertain outlook for European financial markets. According to a balance statistic of -95% of respondents, volumes of business have fallen for the fourth consecutive quarter. Fee income has declined, reflecting low levels of capital issuance and a weak M&A market. Trading income is also seen as having fallen, following a summer season when European financial markets remained more stable than many had expected. This may have been a welcome respite for investors, but was less helpful for those looking to trade off market volatility.

Firms are taking a greater interest in the opportunities that might flow from mergers or strategic alliances.

The uncertain economic picture and worries about the future of the eurozone continue to cast a deep shadow. This is illustrated by the decline in retail business reported by a majority of securities traders. Respondents also report weaker overseas business and, most tellingly, the sixth consecutive quarter of falling activity with financial institutions.

Faced with weaker revenues, securities houses have made some headcount reductions and are keeping total costs under control. Even so, costs per transaction continue to rise and almost all those surveyed report another fall in profitability. The clear implication is that the sector needs to do far more to reduce costs to a sustainable level. Unfortunately, new regulation is making this even harder to achieve. A balance statistic of +95% expect compliance spending to increase during the year ahead, and regulation is the dominant driver of capital investment.

All those surveyed expect weak demand to remain an obstacle to expansion during the coming year, and more than half expect to see no growth from their business. Falling profits, a growing regulatory burden and weak demand have given rise to overcapacity, which is likely to result in consolidation in some sectors. Indeed, for the first time in many months firms are taking a greater interest in the opportunities that might flow from mergers or strategic alliances. This implies that 2013 may see consolidation eliminate some overcapacity from the securities markets.

Investment management

Investment managers remain the most optimistic sector of financial services, buoyed by the prospect of stronger fee income and improved profitability. Respondents are upbeat about their investment plans and expect to spend more on staff, marketing and new products over the coming months.

Business with financial customers has grown for the third quarter in a row, and this is expected to continue.

For the second quarter running, investment management is the only sub-sector of financial services to report growing optimism. As so often, investment managers are significantly more confident than their counterparts in banking, insurance or the capital markets. This may reflect the sector's innate buoyancy or the fact that, despite the undoubted challenges facing investment managers, many firms remain profitable.

The survey provides another explanation for the sector's confidence, namely that business has held up well and is expected to accelerate over the next few months. Volumes of business have grown and are expected to expand further. The sector did not manage to increase fee income over the summer, but this is expected to strengthen during the final months of the year. If costs remain under control, this should drop straight to the bottom line – which may well explain the sector's optimistic view.

Increasing revenue is expected to be driven by two customer groups. The first are financial institutions, investment managers' most important constituency. Business with financial customers has grown for the third quarter in a row, and this is expected to continue. The second key group are retail customers. Respondents expect retail activity to improve over the coming quarter, perhaps hoping that the relative calm of European equity markets over the summer may attract investors back into the market.

Investment managers' survey responses on costs are slightly contradictory. Total operating costs are reported to be remaining stable, but numbers of employees and staff costs are both seen as rising. It is also particularly notable that a balance statistic of +66% expect headcount to increase during the next quarter. Despite this, investment managers give a very upbeat assessment of their profitability, implying that they do indeed expect fee income to grow at a faster rate than costs.

The sector's confidence extends to its plans for the year ahead. Strong balances of respondents expect to invest in growth enablers such as marketing, branding and distribution, and 72% expect new products to generate short-term. The desire to reach new customers is also seen as a much more important driver of capital investment than regulation. This is not only at odds with the rest of the industry, it is also inexplicable, given the range of new regulation facing investment managers.

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Copies of the full survey are available from the Confederation of British Industry, tel: 0207 395 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 August and 6 September 2012. A total of 104 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).

Design & Media – The Studio 21310 (09/12)

Printed on paper manufactured in the EU containing recycled fibre.