

Financial services survey

CBI/PricewaterhouseCoopers quarterly survey
Measuring trends and providing insight from the industry*

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Executive summary

The 80th CBI/PricewaterhouseCoopers financial services survey shows a welcome improvement in sentiment. While this owes a lot to the improving economic outlook and a sense that the worst of the crisis may be past, levels of business remain subdued for many sub-sectors. In the short term, the industry still faces several significant hurdles.

Financial services is enjoying an unmistakable improvement in confidence

The survey shows welcome and unmistakable signs of recovery in financial services sentiment, which reaches its most positive level since 2004. Overall volumes of business are also reported to have grown for the first time in two years (see Figure 1). This is not to say that all is blooming in the financial services garden, but it does show that there is growing clarity around the industry's medium-term outlook. Some institutions may still face a threat to profitability, but they are at least able to quantify the potential impact with a greater degree of certainty than before.

Most sub-sectors of financial services are feeling optimistic, with securities traders and investment managers particularly upbeat after the recent rally in equity markets¹ (see Figure 2). All the same, some wide variation remains between

the sectors. The optimism of banks and insurers is tinged with caution, and building societies continue to feel pessimistic.

The outlook may be improving, but the crisis is still seen as having caused long-term damage

Respondents increasingly take the view that the financial crisis is unlikely to worsen. The industry is

reassured not only by stronger securities markets, but also by improved money market liquidity² and a more stable housing market³. Furthermore, there is an increasing consensus that the UK economy will grow in 2010, albeit slowly⁴.

Even so, there is no real expectation that the UK financial services industry will return to the buoyant position it occupied three or four years ago. Underlining this view, more than two-

Figure 1: Optimism and Business Volumes

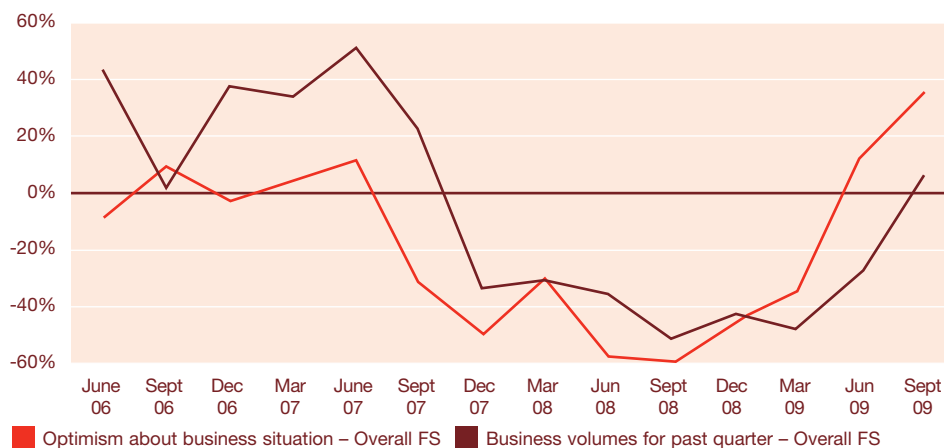
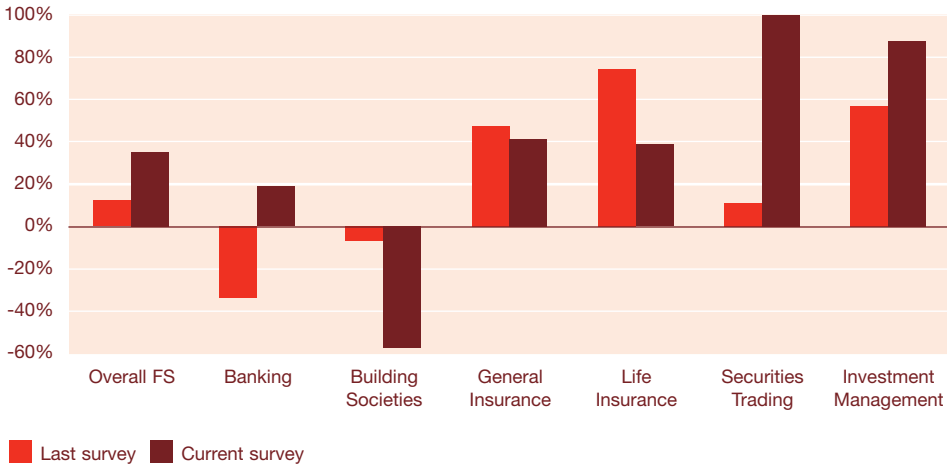


Figure 2: Optimism about overall business situation – Key sectors



thirds of those surveyed continue to feel that the financial crisis has damaged UK competitiveness (see Figure 3a, 3b and 3c).

The industry still faces considerable challenges. Cost cutting remains a key focus

Even if the outlook for financial services is improving, the industry faces a number of short-term challenges. First, forecasts for business volumes remain tentative in several sectors, and are negative among insurers. Second, banks and building societies' non-performing loans continue to grow. Third, many sectors face increasing pressure on profitability. And fourth, concerns about new regulation and the costs of compliance are on the rise.

These challenges mean the industry's growing optimism retains a degree of caution. This manifests itself in a number of ways. There is a near universal focus on customer retention and cross-selling and cost control remains a key priority. Most notably, headcount is falling across most areas of financial services. Things may be looking up, but that does not mean that the autumn will be a happy period in every corner of the industry.

Figure 3a: Impact of Credit Crunch on UK Financial Services Competitiveness (March 09)

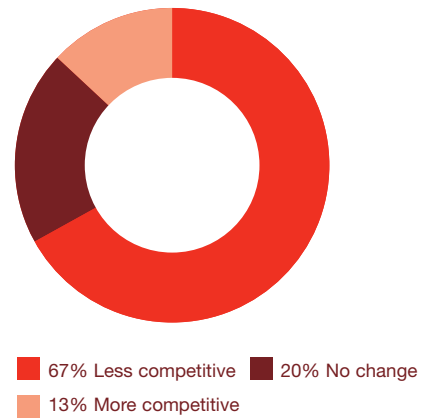


Figure 3b: Impact of Credit Crunch on UK Financial Services Competitiveness (June 09)

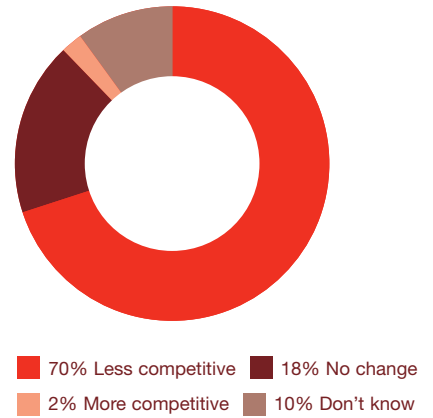
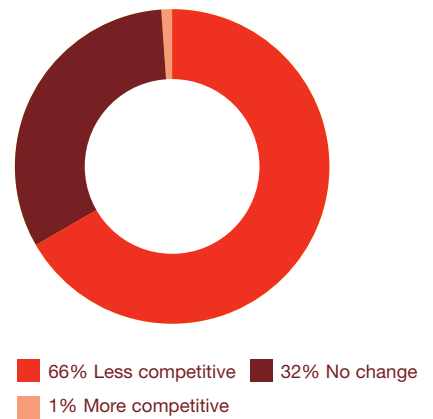


Figure 3c: Impact of Credit Crunch on UK Financial Services Competitiveness (Sept 09)



Please note that, due to rounding, figures do not always add up to 100%.

1 'FTSE hangs onto 11-month high', Financial Times, 14.09.09
 2 'High levels of liquidity fuel gains for equities', Financial Times, 12.09.09
 3 'House price bounce extends into August', Nationwide, 27.08.09
 4 'UK Economic Outlook', PricewaterhouseCoopers, 14.07.09

The possible impact of “tougher” regulation remains a worry for the banks, and the majority expect to spend more on compliance during the coming year.

Banking

Banks are feeling more confident for the first time since 2007. Business remains subdued but there are hopes of a retail-led recovery in the coming months. However, the sector’s optimism is partly offset by concerns about further impairments and the potential impact of fresh regulation.

The banking sector is enjoying a clear upswing in confidence, with a balance statistic of +20% feeling more optimistic. This is the most positive response from the banks since June 2007, before the start of the crisis. The banks’ improving mood does not signal an end to their problems, but it does show that macro-economic improvements are bringing welcome relief to their outlook.

Thus far however, the banks’ confidence is based more on sentiment than performance. The predicted uptick in business volumes has not materialised, and most customer groups performed poorly over the summer. Even so, a modest balance of respondents now feel that business will recover during the autumn. Commercial activity is predicted to remain weak, but retail demand is expected to take up the reins. This imbalance is not unusual during a recovery phase, but it is a reminder that the initial stages of economic recovery are likely to be tentative.

Having widened their average spreads during five of the six

previous quarters, the banks’ margins now appear to have stabilised. It is unlikely that banks will be able to achieve any further uplift in lending margins, but a slight easing of funding concerns could point to potential savings on the liability side. The value of non-performing loans continues to climb, but as this tends to be a lagging indicator the banks were expecting the rise and are increasingly confident they can absorb any further losses from existing reserves. The sector’s desire to protect profitability means that cost reduction remains a theme. Even if radical job cuts are off the menu, the banks continue to reduce numbers employed.

The possible impact of “tougher” regulation remains a worry for the banks, and the majority expect to spend more on compliance during the coming year. Defensive growth strategies remain the order of the day, as the banks focus on retaining their best customers and selling more products to the remainder.

Building societies

Building societies are once again feeling downbeat about their business situation. Signs of stabilisation in the housing market provide some cause for cheer, but funding difficulties continue to put pressure on the sector’s profitability. Forecasts for growth are firmly on the pessimistic side.

Building societies have returned to a pessimistic outlook. Headline

confidence has fallen back to a strongly negative level, unsurprisingly considering the numerous challenges facing the sector. It seems that June's slight improvement in sentiment – the first for two years – was a blip. Almost all respondents experienced a decline in volumes of business during the summer.

In a positive vein, the survey results do include some cautious signs of optimism. A small number of respondents expect business to pick up during the autumn, a view that reflects the recent increases in house purchase activity⁵. It is also notable that the balance of respondents expecting non-performing loans to grow has fallen from +95% in June to just +18%. An improving view of asset quality is consistent with the stabilisation in arrears reported by the Council of Mortgage Lenders⁶ and recent month-on-month improvements in national house price indices⁷.

Despite these tentative green shoots, the building societies still face some fundamental challenges. The sector's ability to generate sustainable profit is the most critical issue, and average spreads are seen as remaining under intense pressure. Most societies continue to find funding in the wholesale markets difficult, and intense competition from the banks is keeping retail finance expensive. The societies' need to maintain liquidity levels is also forcing them to hold more low-yielding assets, putting further pressure on net margins.

In these circumstances, it is not surprising that the sector remains fairly gloomy about its medium-term outlook. The societies continue to cut operating costs, and almost all respondents are reducing their headcount. Customer retention is the major focus of planning for the year ahead, and 89% of respondents do not expect their business to grow before the end of the year.

General insurance

Encouraged by the improving economic picture, general insurers remain in optimistic mood. However the short-term outlook for higher premiums is less encouraging. Many products face very competitive pricing and customer activity is predicted to decline.

General insurers are continuing their recent run of confidence and remain optimistic about their business situation. Even so, this sense of wellbeing is not fully supported by their other responses to the survey. On the upside, a modest balance say that volumes of business and the value of premiums increased during the quarter. Less positively, this growth is now expected to level out and activity across all customer categories is reported to be on a downward track.

Overall, general insurers are not generating the growth in premiums that they had hoped would offset their low investment returns. In the face of intense competition, underwriters are struggling to

increase their rates. With the sector as a whole remaining well capitalised, there is excess underwriting capacity in many markets. High volume, commoditised lines such as motor are particularly competitive. Add to this the view that claims costs will continue to rise, and it is not surprising that profitability is expected to decline during the coming quarter.

Given the uncertain outlook for premiums and profitability, general insurers' continuing confidence must reflect the increasing signs of recovery in the wider economy⁸. Nonetheless, the sector retains a degree of caution about its outlook. This is illustrated by the balance statistic of -42% expecting to reduce headcount, the most pessimistic such response since 2003. Marketing expenditure too continues to fall, as insurers focus on reducing discretionary expenditure. One area seeing higher levels of planned spending is compliance. A majority of insurers now expect to spend more on this area during the coming year, as they respond to Solvency II and other regulatory issues.

5 'July house purchase lending up', Council of Mortgage Lenders, 14.09.09

6 'Possessions fall and arrears flatten in second quarter', Council of Mortgage Lenders, 14.08.09

7 'House price bounce extends into August', Nationwide, 27.08.09

8 'UK Economic Outlook', PricewaterhouseCoopers, 14.07.09

Life insurance

Life insurers have sustained the increased optimism seen at the last quarter, even though demand for their core products remains subdued. In the face of weak new business levels and declining profitability, the sector remains firmly focused on managing costs.

Building on June's strong upswing in sentiment, life insurers remain more positive about their situation – although the backdrop remains uncertain. Volumes of business continue to fall and the value of new business remains on a downward track. Customer activity is also reported to be declining across the board. This picture reflects the continuing weakness of demand for the industry's core investment and protection products. Life companies had hoped for an improvement in their overall profitability, but this has not materialised.

Considering this relatively downbeat picture, the sector's optimism is most likely based on the view that demand will improve at some point in the future. This view is sustained by the anticipated improvement in the general economic situation⁹, the relative strength of investment markets during the spring and summer¹⁰, and stabilisation in the housing market¹¹.

Whatever life companies' hopes for the future may be, for now they remain on a defensive footing. The sector's plans for growth are firmly

focused on customer retention and improved levels of cross-selling. Taking costs out is a strong theme, with a balance statistic of -77% reducing employee numbers and a majority planning to take job cuts further. Concerns about the potential impact of regulation on business development have reached their highest point in over a year, and compliance – particularly with reference to Solvency II – continues to be a significant driver of spending.

Securities trading

Securities traders are enjoying life again, thanks to the strong rebound in equity markets. Forecasts for revenue and profitability are more bullish than at any point since the beginning of the financial crisis. There are some signs of caution, but the sector is investing for future growth.

Securities traders' optimism has improved dramatically since June. For the first time in the twenty year history of the survey, all respondents are feeling optimistic about their business situation. This remarkable improvement parallels the strong rebound in equity markets since March. During the six months to the end of August the FTSE 100 index increased by 35.7%¹², recovering a great deal of lost ground and providing a powerful stimulus to trading commissions. A handful of rights issues and large corporate transactions over the summer also boosted underwriting and advisory fees, though absolute levels of activity remained somewhat

subdued. As a result, more than 90% of respondents enjoyed stronger volumes of business and levels of income during the quarter. Stronger demand from financial institutions was a particularly welcome feature of the results. More than two-thirds of securities traders expect to see further revenue growth during the autumn, as well as increased activity with retail customers.

Securities traders are not just feeling upbeat about their revenue prospects. Profitability is reported to have increased by more than 90% of respondents – the highest figure for ten years – and is expected to strengthen further. Employment levels are trending downwards, but with staff costs remaining flat it may be that bonus expectations are growing. In another sign of confidence, the sector is increasing its capital expenditure on IT and infrastructure. The investment is aimed at improving efficiency, but also at handling more business and reaching new customers. Even fresh concerns about the threat of competition could be interpreted as a sign that business is picking up.

A few small clouds cast a shadow over this optimistic picture. Worries about the threat of regulation are climbing steeply, as the sector

9 'UK Economic Outlook', PricewaterhouseCoopers, 14.07.09

10 'FTSE hangs onto 11-month high', Financial Times, 14.09.09

11 'House price bounce extends into August', Nationwide, 27.08.09

12 Markets Data, FT.com, 11.09.09

contemplates the potential impact of supervisory changes. Nearly three-quarters of respondents expect to increase their compliance spending. And despite the bullish forecasts, levels of demand remain a universal concern. This lingering uncertainty is having an effect on the sector's growth plans, which involve a combination of aggressive and defensive tactics.

Investment management

After a buoyant six months for equity markets, investment managers are in ebullient mood. A welcome return to revenue growth has left the sector feeling much more bullish about its prospects. Costs are being allowed to grow for the first time since mid-2008.

Almost all investment managers are feeling optimistic about their situation, a further improvement on June's positive sentiment and the strongest response since 2005. It is hardly surprising that the strength of equity markets since March¹³ has left investment managers feeling cheerful; after all, higher market values mean higher management fees. Nonetheless, it is a welcome response from a sector which has endured some difficult times over the past twelve months.

Other survey results confirm the impression that investment managers have had a good quarter. Volumes of business increased and fee income is reported to have grown by

the largest balance statistic since 2007. Respondents remain cautious about the immediate future, but this growth is reassuring given the damage done to revenues by falling markets and investor redemptions during 2008 and early 2009. It is particularly remarkable that demand has been so strong during the usually quiet summer period. When the effect of several quarters of cost reduction is added to the increase in revenue, it is not surprising that more than half of respondents report an increase in profitability.

There are several signs that the improvement in business conditions is already changing investment managers' attitudes. To begin with, there has been an abrupt increase in operating expenses, reversing the sector's recent run of cost reductions. More unexpectedly, staff numbers are reported to have increased and a balance statistic of +90% expect to add to headcount during the autumn. These changes are surprising, given that many firms had planned further staff reductions for 2009 following the cutbacks of 2008. Even if some of these plans are now on hold, it is hard to believe that headcount is increasing across the sector. Another sign of growing confidence is the lesser importance attached to customer retention. Instead, investment managers are showing increasing interest in new services, with several firms planning to roll out hedge fund products inside UCITS wrappers. Expectations for M&A activity, which have grown in

recent quarters, remain steady. The past six months has seen the announcement of some high-profile transactions including the sale of Barclays Global Investors to BlackRock¹⁴, and we would not be surprised to see further deal-making activity in the sector.

About this survey

This survey was carried out between the 19th August and 2nd September. A total of 89 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).

¹³ 'High levels of liquidity fuel gains for equities', Financial Times, 12.09.09

¹⁴ 'BlackRock buys Barclays BGI', Financial Times, 12.06.09

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Copies of the full survey are available from the Confederation of British Industry, tel: 020 7395 8071, email address bookshop@cbi.org.uk. The price for a single quarter for members is £60 and for non-members £95; an annual subscription for members £210 and for non-members is £360.

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