Financial Services Survey

CBI/PricewaterhouseCoopers quarterly survey

Sharing insights and trends from the financial services industry*

December 2006 – Number 69

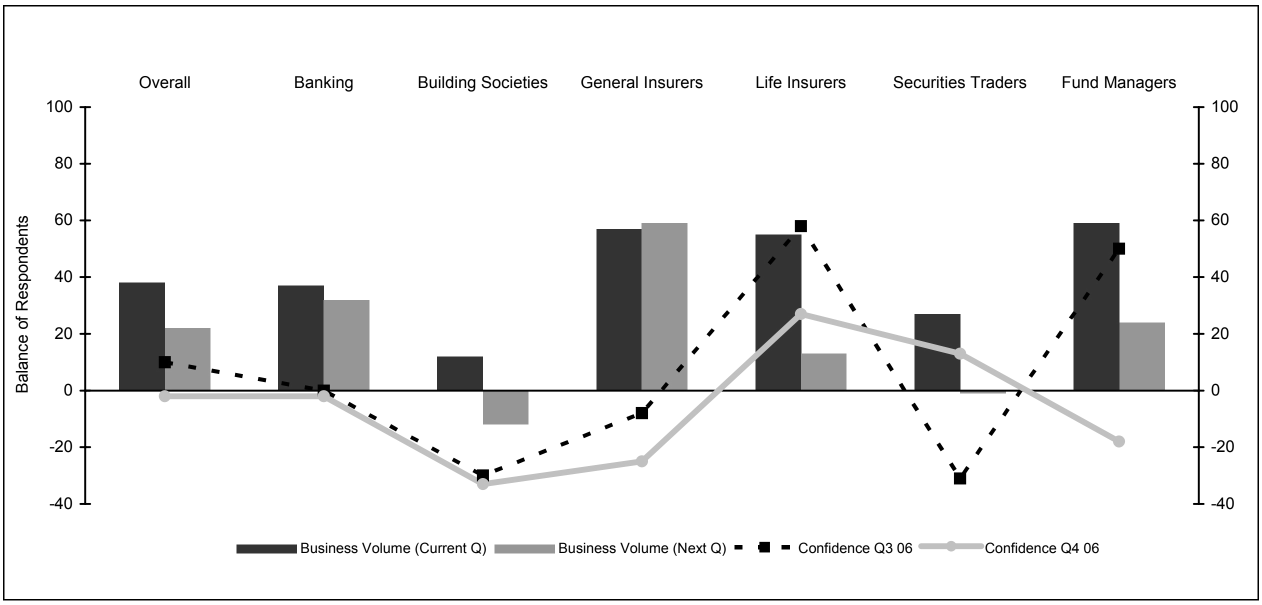
“The positive employment message is welcome, given that several sectors show a degree of uncertainty about their longer-term outlook”

The 69th CBI/PricewaterhouseCoopers financial services survey shows the industry’s overall level of confidence declining marginally after last quarter’s recovery in sentiment. Most of the major sub-sectors report weaker sentiment, although in several cases this appears to be the result of short-term considerations rather than any major shift in the longer term outlook. In most cases the volume growth predicted at the last survey has come through, and the majority of sub-sectors continue to predict further expansion in the coming quarter. Forecasts for the next period’s revenue streams remain positive, but there is notable variation between sub-sectors when asked to consider the outlook for the retail customer segment.

The industry has maintained a stable cost base during the quarter, but an increase is widely predicted for the coming period. The key swing factor is staffing, with every major sub-sector reporting an increase in headcount during the past three months and predicting further recruitment for the first quarter of 2007. This is an exceptionally consistent response, although trends in staff turnover vary between the sub-sectors.

The positive employment message is welcome, given that several sectors show a degree of uncertainty about their longer-term outlook. Regulation is a mounting concern for many sub-sectors, non-performing loans preoccupy the lenders and levels of competition are cited as a concern by the largest percentage of respondents in ten years.

Figure 1: ***“Most of the major sub-sectors report weaker sentiment, although in several cases this appears to be the result of short-term considerations”***



Banking

Overall sentiment in the banking sector remains steady, with a balance statistic of -2% reporting slightly reduced levels of confidence. However, this neutral sentiment glosses over some apparently contradictory responses, suggesting a degree of uncertainty over the sector's outlook. An illustration of this is that while a balance statistic of +32% expect business volumes to continue their growth into the coming quarter, balance statistics of -29% expect activity with commercial and retail customers to decline over the same period. In fact, several of the banks' responses send out mixed messages about the sector's true level of confidence. On the positive side, average spreads are seen as having stabilised after six quarters of widely reported decline. This fits with anecdotal evidence that recent interest rate increases have slightly eased downward pressure on net interest margins. The banks also show increasing confidence in their ability to increase fee and commission income going forward. On the pessimistic side of the equation though, the banks are becoming more preoccupied about future levels of demand. And although levels of investment are expected to increase, the focus of spending appears to be shifting away from the front office towards efficiency and replacement.

Bad debt exposure is another important area where the banks' sentiment seems to be finely balanced. The sector's overall view is that the situation has stabilised after five quarters of growth in non-performing loans, primarily in unsecured consumer lending. However, responses to a one-off question about unsecured consumer lending show that 30% expect further deterioration while none expect an improvement. These results bear out recent trading statements, in which most of the major banks were unwilling to say whether the peak of consumer credit provisioning had been reached. Although few of the banks are expecting to report any major increase in charge-off rates at the year end, the continuing rapid growth in IVAs has left the sector concerned that consumer delinquency could deteriorate further in 2007.

Building societies

A balance statistic of -33% of building societies are feeling less confident about their business situation, despite reporting a successful fourth quarter. Small positive balances report higher volumes of business and levels of income, while costs were held in check and most respondents saw profitability improve. Nonetheless, predictions for the coming quarter suggest that a slowdown in mortgage activity is expected, despite recent increases in average house prices. For example, balance statistics of -12% expect volumes of business and the value of all types of income to decline in the coming quarter, and a similar balance expect activity with the all-important retail segment to fall. Competitive activity is also expected to put average spreads under renewed pressure after two quarters when some relief had been predicted. Furthermore, a balance statistic of +63% predict the value of non-performing loans will grow in the first quarter of 2007. Although the absence of negative equity within the UK housing market should prevent this turning into significant losses, it is nonetheless a notable result. However, it is more likely to reflect a large number of respondents expecting a small increase in arrears than the other way around.

If the gloomy outlook for the sector's activity levels and competitive situation is fairly straightforward to interpret, responses in the areas of cost and profitability are more difficult to fathom. The sector seems to be returning to recruiting, driven by higher volumes of business and increasing staff turnover levels. Even so, costs are predicted to remain flat in the coming months and a balance statistic of +48% expect profitability to increase, despite the forecasts of lower revenues and higher non-performing loans.

General insurance

Overall confidence in the general insurance sector declined over the period as a balance statistic of -25% said they felt less optimistic about the sector in December, compared to -8% three months ago. This is in contrast to respondents' views about the prospects for their own organisations. Balance statistics of +59% expect improving volumes over the next three months and +33% expect improving profitability, so clearly many insurers plan to outperform a problematic trading outlook. The sector has also seen some widely divergent trends between different sub-segments. For example, the sector has seen positive trading statements from catastrophe re-insurers which highlighted low hurricane-related claims, whilst at the same time motor insurers have struggled with a poor rating environment.

The claims trend is, generally, deteriorating. A balance statistic of +31% of respondents expect claims to increase over the next 12 months. The exceptionally light catastrophe claims experienced this year means that a return to trend going forwards will amount to a deterioration. As regards UK personal lines claims, there have been recent concerns that personal injury claim amounts will increase, due both to a new edition of the Ogden Tables and to recent judgements linking periodic payments to earnings indices rather than prices indices as before. As many as 96% of respondents cite replacement as a reason for new capital expenditure, which suggests that legacy systems are at last being replaced rather than 'worked around'. The outsourcing trend may have run its course for the moment, as a balance statistic of +60% expect staff numbers to increase over the next three months.

Amongst the insurance brokers, confidence has taken a dip in recent months as rates, at least outside of catastrophe-related business, have softened and London market brokers suffer from a weak US dollar. A balance figure of -26% now expect profitability to decline over the coming three months, the first significant negative opinion this year. Custom for brokers from private individuals continues to decline as the business migrates to direct and internet broker channels.

Life insurance

Confidence about the sector remains firmly in positive territory with a balance statistic of +27% feeling more optimistic. A balance figure of +55% saw the value of new business improve in the last three months compared to a figure of -79% which saw a decrease in the last quarter. Business with private individuals continues a strong trend with a balance statistic of +67% expecting an increase over the next three months. The 'A-Day' impact on life sector volumes appears to be continuing.

The survey was conducted before the tax restrictions on pensions term insurance and the December 12th white paper titled "Personal accounts: a new way to save" which set out proposals to implement the National Pensions Savings Scheme (NPSS), both of which may have diminished optimism somewhat since the date of the survey. The best hopes of the industry were disappointed in that the NPSS will not be sold under private sector brands. However, the industry's worst fears were listened to as there is a £5,000 cap on contributions per individual per annum, and it will generally not be possible to transfer funds out of the private system into the NPSS until 2020. The life industry must now make the new system work.

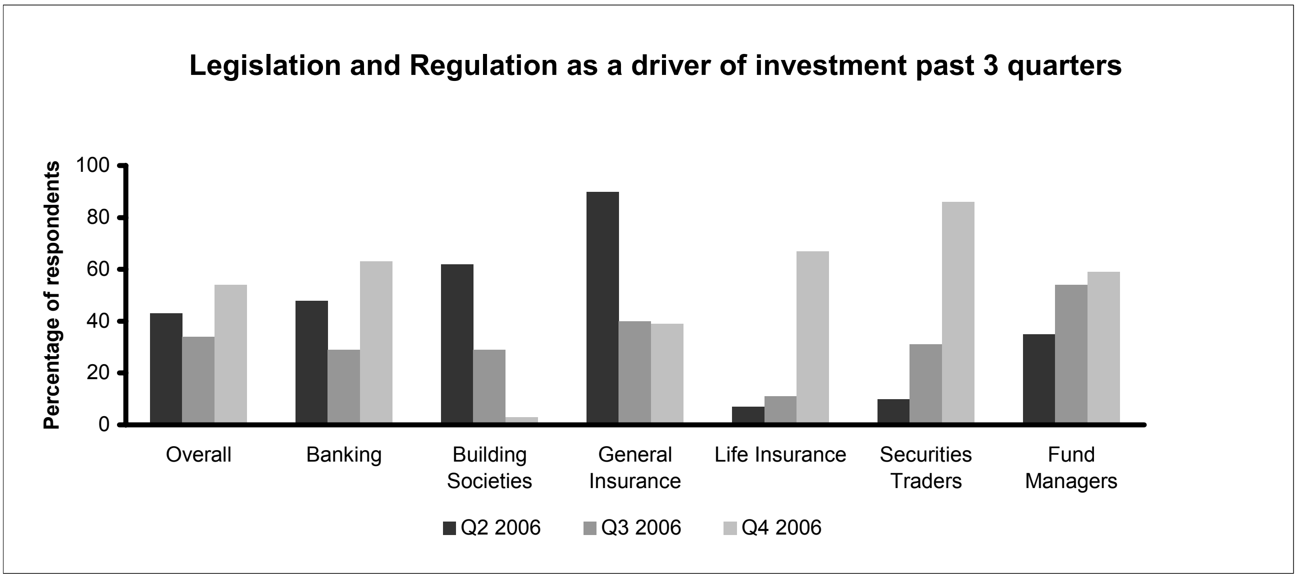
It is noticeable both that the sector is expecting to recruit (a balance of +60% expect the number employed to increase over the next three months), and that the availability of professional staff, clerical staff and systems capacity overseas are all cited as constraints on expansion, whereas none were cited three months ago. It looks as if off-shoring is, for the moment, taking a back seat behind developing capacity at home. Unlike in previous quarters, capital expenditure is targeted at replacement. A figure of 68% of respondents cited this as a reason for capital expenditure compared to zero last time. As with the general insurers, the response suggests that legacy systems are, at last, being tackled. There is optimism that total operating costs will fall; a balance of -27% of respondents expect such costs to fall over the next three months compared to +63% who predicted an increase last time.

Securities traders

Securities traders report a modest rally in sentiment, with a balance statistic of +13% feeling more optimistic. The fears of the previous two quarters, which were sparked by May's stock market correction, seem to have largely evaporated. Instead the results show a picture of recovery, with a balance statistic of +27% reporting higher volumes of business during the quarter. Small positive balances also report increases in all types of income and in activity levels with most categories of customer. Furthermore, in many of these areas growth is expected to continue or at least stabilise in the coming quarter. This is a more encouraging short term outlook than we have seen in recent surveys, but it is noticeable that respondents are less confident when asked to look further forward. For instance, levels of demand and competition are cited as probable limitations on future business by 87% and 86% of respondents respectively. Now that the full impact of the Markets in Financial Instruments Directive is becoming clearer, regulation is also emerging as a growing concern for the future. It is notable that all respondents expect to invest more in regulatory compliance in the coming year.

A large majority of securities traders report higher operating costs. Most respondents also expect expense growth to continue, so much so that the sector's profitability is predicted to decline in the coming quarter. Two key drivers of cost growth are clearly identified. Firstly, a balance statistic of +59% say that staff turnover has increased during the quarter and is likely to grow further in the coming period, the highest such figure from any of the survey's major sub-sectors. High turnover of staff is endemic in the sector and the continual need for recruitment has the effect of pushing up remuneration levels, as well as giving rise to one-off recruitment and training costs. Secondly, a balance statistic of +73% report an increase in fees paid, the highest such result in eight years. For traders, these costs are comprised of exchange fees and settlement fees. The sector as a whole is hoping that intensifying competition among stock exchanges and clearing houses will start to drive these costs down, and a neutral balance of respondents predicts a stable outlook for these costs in the coming quarter.

Figure 2: ***"Regulation is a mounting concern for many sub-sectors"***



Fund managers

A balance statistic of -18% of fund managers are feeling less confident about their business situation. This is the sector's third consecutive swing in sentiment, and in this case the pessimistic outlook seems rather at odds with some of the sector's other more positive responses. The value of commission income is the only potential concern identified in the revenue area, reflecting the sector's belief that initial fees will decline over time. Other top-line indicators are strongly positive, with volumes of business expected to continue on their current upward trend. Business with all categories of customer is also expected to either stabilise or grow in the coming quarter. This confident assessment reflects the sector's positive view of its own long-term prospects, a view which arises from extremely high levels of global liquidity and the growing demand for long term investment management.

It is this positive frame of mind which is encouraging fund managers to grow their cost base and staffing levels at rapid rates. A balance statistic of +90% expect total operating costs to climb in the next three months. The increase in expenses is partly attributable to stronger business volumes, but also and more importantly to an investment programme aimed at preparing the sector for future increases in demand. The major areas of investment continue to be the rationalising and refreshment of fund managers' product ranges. It is this focus which explains the balance statistic of +86% planning to spend more on IT in the coming year, the highest such response in over six years. The sector's programme of increased spending is expected to erode profitability during the first quarter of 2007, and it is probably this short-term consideration that has driven respondents to give a pessimistic assessment of their overall business situation.

However, when developments such as December's white paper 'Personal accounts: a new way to save' are taken into account, the longer term picture for the sector must surely be considered an upbeat one.

New economy

The rapid growth in customer adoption over the last five years now appears to be slowing, with roughly one in four customers using the Internet to transact at the average financial services company. Most financial services providers expect more of their customers to be using the Internet in a year's time, on average 5% more than use it today. This contrasts strongly with past growth rates of roughly 40% per annum. The biggest obstacle to the adoption of online services remains the preference of customers to use other channels, with three-fifths of companies continuing to report this as a concern.

The survey results imply that customers are slightly more willing to use call centres than the Internet, with roughly one in three customers using call centres at the average financial services company. Many customers, however, continue to prefer to transact through traditional channels such as branches and intermediaries. As a result, many financial services providers are trying to improve efficiency by asking intermediaries to use the Internet to transact with them. This seems to be a mixed success; the average respondent predicts that only one in four of its intermediaries will be sending transaction data this way one year from now.

About this survey

The survey was carried out between 20th November and 6th December 2006. A total of 73 companies responded including banks, building societies, finance houses, securities traders, fund 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)

Further contacts

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.

For further information about this bulletin, please contact Katie Ryalls, PricewaterhouseCoopers on 020 7212 3277.

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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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