

Financial services survey

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

March 2008 • Number 74



Contents

Executive summary	04
Banking	06
Building societies	07
General insurance	07
Life insurance	07
Securities trading	08
Fund management	09
About this survey	09
Contacts	10

Executive summary

The 74th CBI/PricewaterhouseCoopers financial services survey shows the industry waking up to a harsh new reality. Although sentiment improved slightly since the autumn, respondents remain notably depressed and are facing a longer, slower road to recovery than had previously been expected. Concerns over asset write-downs and liquidity persist, and are now accompanied by growing worries over the economic outlook and the strength of consumer demand. The credit crunch is clearly recognised as affecting the whole industry, with many sub-sectors acknowledging the need for real adaptation in response to their new environment.

The problems show no signs of ending

The industry's overall sentiment has pulled back slightly from the depths of the December survey, but remains seriously depressed. This survey took place just before the rescue takeover of Bear Stearns and the Federal Reserve's 75 basis point rate cut¹; a week is currently a long time in these financial markets. Only on eight occasions in the last eighteen years has confidence been as low as this (see Figure 1). Lenders and traders were feeling less negative than before, but remain downbeat in absolute terms, and insurers' pessimism is growing as the impact of the credit crunch on their businesses becomes clearer (see Figure 2).

The industry's worries over asset impairments are persisting, and the expectation remains that further pockets of risk will be uncovered. There is also a wider acceptance that the credit crunch is now affecting all

areas of financial services. Despite repeated collective actions by central banks since the end of last year – the most recent of which took place after this survey was conducted² – global credit markets remain strained. The result is growing disquiet among respondents about the probable length and depth of the credit crunch, as well as its ongoing effect on funding and its potential impact on consumer confidence and the wider economy.

Falling consumer demand is now a major concern

The survey results reveal new concern over the outlook for top-line growth right across the industry. With the exception of general insurers, all the major sub-sectors now forecast slowing business volumes and falling revenue streams for the coming quarter. Activity with retail customers has fallen notably, and the strongest negative balance of respondents since 1990 now predict further weakening in consumer

¹ Fed leads Bear Stearns rescue', *Financial Times* – 15.03.08; 'Fed cuts rates by 75 basis points', *Financial Times* – 18.03.08

² Fed leads \$200bn liquidity boost', *Financial Times* – 11.03.08; 'Bank of England pumps extra £5bn into money markets', *Financial Times* – 17.03.08

Figure 1: Optimism about Business Situation - Overall FS

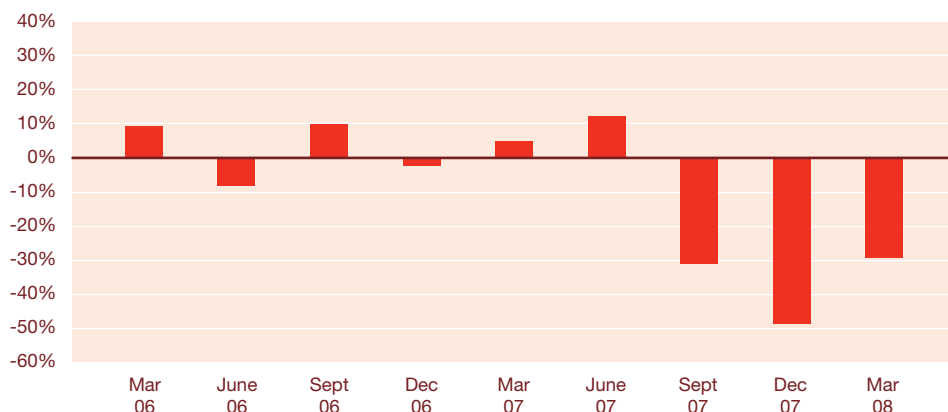
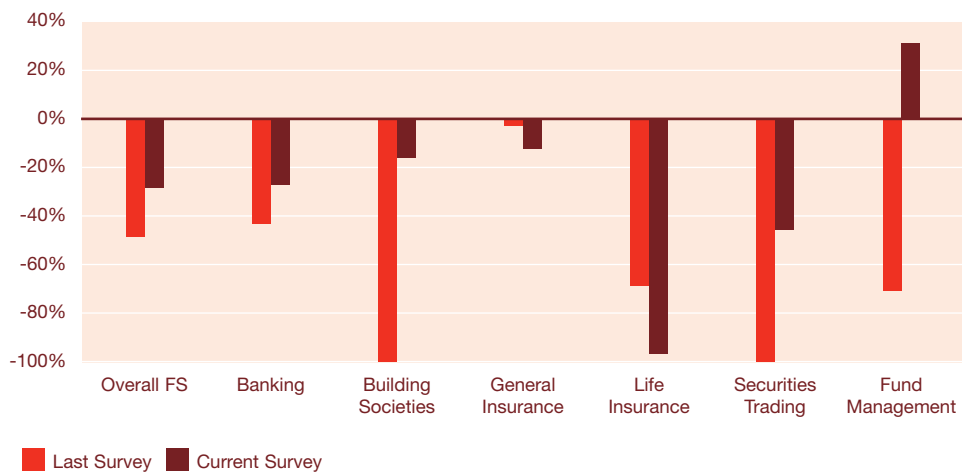


Figure 2: Optimism about Business Situation - Key Sectors



demand. It is also notable that almost all respondents now doubt whether normal conditions will be resumed before the end of the year. This is a significant change from the previous survey, when opinions were more divided.

Business models are being adapted for a long siege

Faced with what is now expected to be a more prolonged downturn in

demand, the industry has begun to adapt itself accordingly. It is true that average spreads have widened, as some sectors use falling demand as an opportunity to shore up product profitability. However, investment plans have shifted to a more cautious stance. The industry also reports its most negative employment outlook for five years, although it is not clear how deep any staff reductions will be. In summary, the UK financial

services industry is trying to adjust itself to a harsh new reality, and is beginning to prepare for what is likely to be a long road to recovery.

As if credit and liquidity challenges were not enough to contend with, the banks are also feeling increasingly threatened by regulation.

Banking

The banks' concerns over the credit markets have broadened into wider worries about the economy. Commercial business is holding up well, but top-line forecasts are weakening despite some success in re-pricing key lending products. The investment and employment outlook is looking distinctly cool, and fears of regulatory disruption have reached their highest point for several years.

Banking sector pessimism has lessened since December, but remains pronounced at -27%. Banks are adjusting to the new realities of the credit market, but are increasingly concerned about the economic outlook for the second half of 2008.

Responses to credit crunch questions clarify this shift in attitude. US and structured credit exposures clearly remain very troublesome, although the banks reported slower than expected growth in non-performing loans and UK arrears remain generally well controlled. However, almost all respondents now expect the credit crunch to last until the year end. This is a real change from December, when the banks were evenly divided into more and less optimistic groups. The credit crunch is also now expected to have a greater top-line impact than previously imagined. Predictions for activity and revenues are becoming more pessimistic, despite the fact that banks have seen their funding costs stabilise recently, and have even been able to widen their spreads via credit re-pricing.

Customer demand remains polarised. While retail cooling is predicted to persist into the early summer, mainstream commercial and corporate banking continues to

perform well. The uncertainty arising from this conflicting economic picture leaves the banks strongly disinclined to commit to capital spending, and particularly reluctant to invest in new services or customer acquisition. The outlook for staffing levels is also the weakest since 1995, although so far this points to industry-wide caution rather than especially severe job cuts.

As if credit and liquidity challenges were not enough to contend with, the banks are also feeling increasingly threatened by regulation. This reflects a gamut of problems from the immediate current account pricing threat, through concern over payment protection insurance remedies, to worries that parliamentary interest in banking regulation as a response to the current crisis could result in hurried legislation.

Building societies

Despite credit market ructions and a clear slowdown in mortgage demand, the societies remain quietly confident in their ability to fund and manage their business. Key to this self-belief has been the sector's recent success in attracting retail and commercial deposits.

After hitting bottom at the end of last year, building societies' confidence has recovered rapidly to a nearly neutral outlook. Respondents evidently feel that their traditional model has stood up well to the current disruption in credit markets. Even so, a balance figure of -89% expect activity to slow – hardly surprising considering the nine-year gross lending lows reported by the Council of Mortgage Lenders just before the survey was conducted³, not to mention the rapidly slowing trend in house price inflation.

³ All loans for house purchase: lending and affordability', Council of Mortgage Lenders – 12.02.08

In fact, it is surprising to find that at least half of respondents reported a brief pickup in activity during the first quarter. Considering the slow pace of new lending, this reflects activity on the liability side of the balance sheet. The uncertainty affecting the banks has allowed the societies to draw on their dependable image and become popular destinations for retail and commercial deposits.

Average spreads are another area where the sector has had a lift. Most respondents saw spreads widen for the second quarter, as vanilla mortgages continued repricing from their recent uneconomic levels. This uplift in margins is now expected to stabilise, although a handful of societies may expect renewed competition, now that the market offers fresh value to lenders. Whilst the sector still expects the availability of funding to restrict new business growth, it remains confident in its ability to manage liquidity – thanks largely to its success in deposit gathering. Other results suggesting improved sentiment include the minimal level of credit losses, the strength of IT investment plans, and positive predictions for the coming quarter's staffing levels.

General insurance

General insurers remain relatively insulated from the effects of the credit crunch. Although smaller, commercial insurers continue to feel real pricing pressure, the large retail firms are feeling more confident about their outlook – as demonstrated in the sector's positive plans for marketing and investment.

The general insurance sector maintains the relatively stable outlook it has held since the start of 2006. Considering the sector's other positive survey responses, we do not

place too much weight on the slight decline in headline optimism from -2% to -12%.

Of the major sectors covered by this survey, general insurers probably consider themselves to be the least affected by the credit crunch. Perhaps it was this sense of immunity that made them the most consistent in their prediction of how long-lasting the crunch would be. Although respondents now see funding costs as having a greater impact than previously thought, they remain unconcerned about their ability to raise capital. Any short term concerns the insurers may have felt over portfolio valuations have been consigned to history; the sector has faced that pain already, and most players appear to have minimal exposure to illiquid credit instruments.

Nonetheless, it is still notable that performance diverges between personal lines and commercial business. Both of these customer segments are seen as generating growing volumes of business, but personal lines are seeing some hardening in motor and property rates, where the pricing outlook is flat to positive. In contrast, commercial rates are widely expected to fall by 10% or more this year, and the exceptional commercial claims experience of 2007 is unlikely to be repeated.

The sector clearly continues to do increasing amounts of business online, especially in the personal arena. This trend is supported by survey findings which show a reduction in costs per transaction and bullish marketing plans for the year ahead. Positive plans for IT investment also suggest that respondents expect further growth in the volume of business transacted

over the internet. These results show that many general insurers – especially the larger retail firms – remain confident in their business model and are increasingly comfortable with the ongoing commoditisation of their core products.

Life insurance

Life insurers report a collapse in confidence, as investment and housing market uncertainties threaten their business from all sides. In addition to these challenges, the sector is having to invest more on compliance, so it is small wonder that reductions in staffing and capital expenditure are on the cards.

The life insurance sector's outlook has moved from pessimism to downright despair, with a balance figure of -98% feeling less confident. The sector's misery is directly linked to the uncertainty in investment markets, and its knock-on impact on consumer attitudes. The life companies' most immediate worry is probably the continued uncertainty over their investment portfolios caused by ongoing market volatility. However, it is striking to note that responses to credit crunch questions show a marked shift away from asset price concerns to worries over revenue growth; worries that show the sector is increasingly troubled about its medium-term outlook.

It is easy to see why. A strong majority now predict falls in new business. This holds true across all customers segments, but retail is the area of greatest concern. The environment of volatile investment markets and cooling house prices present a double threat for the sector: Term assurance and protection business is strongly linked to the property market, and

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customers are much less likely to make long term investments at a time of falling equity markets.

Faced by this uncertainty, life companies are becoming increasingly focused on cost reduction. Headcount levels are also expected to fall for the third quarter running, and capital investment plans are the most negative recorded in eighteen years of the survey. Even amidst this gloom, respondents are facing an increasing need to invest in compliance and disclosure. This reflects the ongoing spending on regulation, such as Solvency II and Market Consistent Embedded Value projects. At the time of the survey, there was also growing concern about the implications of the proposed Capital Gains Tax treatment of investment bonds, which would weaken the competitive position of unit-linked products compared to other investment products. The life industry's fears were subsequently realised when the Budget failed to respond to its lobbying on this issue.

Securities trading

Securities traders saw a further significant decline in confidence, albeit not as universal as December's, as concerns persist over the prospects for many of their key activities. For every business performing well, there are others entering a fourth quarter of gloom. Profitability is falling fast, and there are signs of further cost reductions and staff cuts on the horizon.

Securities traders may not be as gloomy as they were in December, but they certainly do not feel they are out of the woods yet and the impact of Bear Stearns will exacerbate that. The sector's outlook remains negative, even if it has improved from

the overwhelming pessimism of the previous survey. Securities houses reported a wholly downbeat set of responses for business volumes and revenue streams, fulfilling their own dire predictions of three months ago. Considering the record recent volumes of trading on many exchanges, this looks surprisingly gloomy.

The explanation lies in decoupling between different business areas. On the one hand, secondary markets – both for equities and bonds – have been very busy since the year end, and prime brokerage activities are performing strongly. On the other hand, primary markets and investment banking remain very quiet, particularly in structured finance.

The sector's growing recognition that some of its businesses face a long road to recovery is reflected in its staffing plans. Headcount forecasts have swung from +55% in December to -26% in the current survey, showing an increasing desire to match cost structures to the prevailing market conditions. If this cloud has a silver lining, it is that many securities houses remain wary of cutting too fast or too deep. Although many fixed income teams have already seen some shrinkage, job cuts remain muted for fear of unintended impacts on other businesses.

It is not only slowing business that keeps the sector gloomy. Profits continue to be hurt by write-downs of asset backed securities, as institutions are forced to hold positions for far longer than they had planned. Furthermore, significant portions of these books lack visible pricing, thus adding to the general uncertainty.

Fund management

Equity market performance since the year end has taken its toll on the fund management sector, even if respondents claim to be feeling more confident. Firms are also becoming more worried about the outlook for customer demand, so revenues are a real concern. We also expect downward pressure on costs to build in 2008. Alternative asset classes may offer a ray of hope, but the need for clearer asset valuations presents a fresh challenge for the sector.

Fund management is the only major sector to report a positive outlook, shifting to a balance view of +31% from -72% in December. This swing is at odds with most of the sector's other responses, and looks even more surprising in the light of recent equity market falls – not to mention unprecedented levels of volatility. Retail and institutional businesses both continue to decline as investors shift into cash, trends underlined by the Investment Management Association's strikingly negative fund flow statistics for January⁴. The only ray of sunshine comes from more active overseas investors, although this is unlikely to make much of a dent on domestic redemptions.

The sector seems to be only concerned with its immediate troubles. The supplementary questions show that a return to 'normal conditions' is not expected before year end, and that revenue growth has emerged as the sector's greatest worry. This stance is borne out by recent public statements from some leading investment firms warning of the threat posed by falling confidence and reduced risk appetites.

After the market turmoil of recent months, respondents are increasingly concerned about the risk of asset write-downs. A stronger focus on asset valuation will be a key feature of 2008, and this will be especially true for alternative asset classes, where institutions have been becoming more ready investors in recent years. As the recent PricewaterhouseCoopers/Economist Intelligence Unit briefing emphasised⁵, the corollary of that interest is a growing desire for clearer reporting, especially of valuation techniques.

Fund managers continue to be cautiously upbeat in their spending and hiring plans. In some cases this may still relate to projects initiated during better times, and unless market conditions improve significantly we expect to see a renewed focus on cost levels in the near future.

About this survey

The survey was carried out between 20th February and 5th March 2008. A total of 79 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).

⁴ Investment Fund Statistics January 2008', *Investment Management Association* – 25.02.08

⁵ Transparency versus returns: The institutional investor view of alternative assets', *PricewaterhouseCoopers/Economist Intelligence Unit* – 10.03.08

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