

Financial services survey

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

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Executive summary

The 76th CBI/PricewaterhouseCoopers financial services survey sees the industry's downturn in confidence becoming even deeper and more prolonged. Revenue streams are slowing across all areas of the industry, with rapidly cooling economic growth and financial market instability the dominant themes. Respondents continue to reassess how severe and long-lasting the slowdown will be, and are becoming increasingly focused on reducing their levels of staffing.

Pessimistic as they are, these views reflect the sentiment of respondents before the unparalleled market turmoil of September began. Since the survey was conducted in late August a series of major global institutions have undergone government rescues, hasty mergers and even financial collapse. We will have to wait for the next survey to fully assess the impact of these developments on sentiment, but the industry is clearly living through exceptional times.

Respondents to this survey may have reported exceptional levels of pessimism, but since the survey was conducted global financial markets have suffered a further and even more severe crisis of confidence. The principal drivers of this crisis were intensifying liquidity concerns, leading to significant downward pressure on share prices. This has been exacerbated by short sellers

to the point where the FSA has introduced a ban on selling short, notwithstanding that it describes it as a legitimate investment technique in normal market conditions. An almost total absence of confidence has taken hold in the financial markets. This has in turn intensified liquidity pressures and has led in just a few days to unprecedented and rapid consolidation in the banking and securities industries. The crisis has also highlighted potential risks associated with settlement issues, although these are yet to become fully clear.

Prior to the recent market upheaval, slowing business was already pushing sentiment lower

Even before the market upheaval of September began, the financial services industry's overall level of sentiment had fallen again, setting a new benchmark of negativity. The current downturn in confidence is not only the deepest seen for eighteen

years, it is now also the most prolonged sequence since the recession of 1990-1991.

Overall sentiment continues to track aggregate business volumes (see Figure 1), which have recorded their steepest decline in almost two decades. Some sectors believe that the rate of decline may slow in the coming quarter, but this is far from a uniform view and no-one is predicting a potential recovery. All the major sub-sectors of financial services remain negative about their business situation, with fund managers in particular reporting a sharp deterioration in sentiment. (See Figure 2)

Revenue streams face increasing economic headwinds

Asset impairments remain an immediate and unpredictable threat to financial services companies, with non-performing loans continuing to grow and increasing attention being

Figure 1: Optimism and Business Volumes

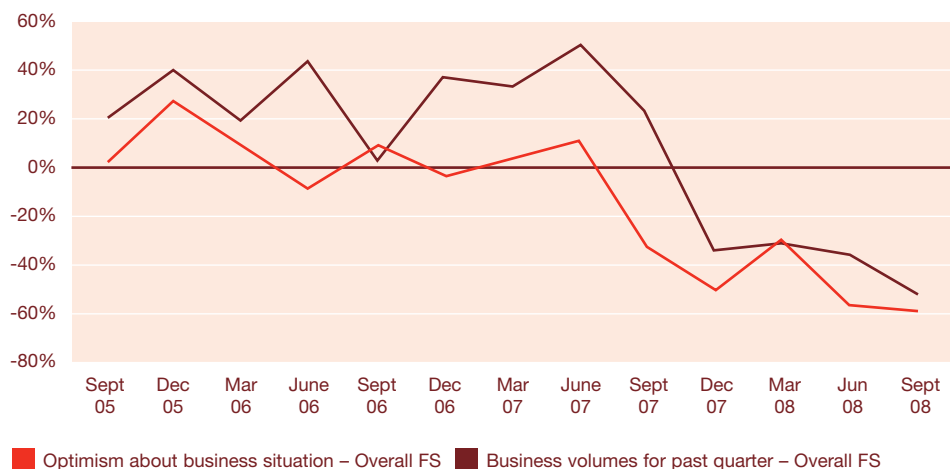
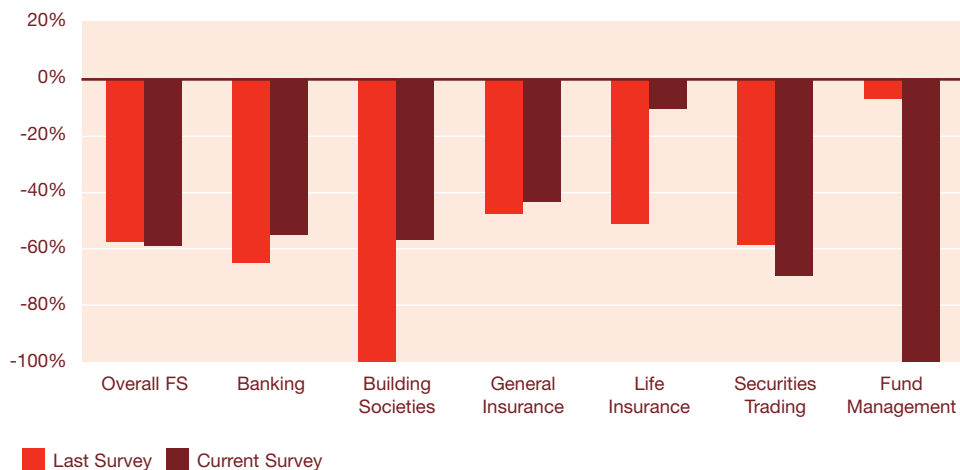


Figure 2: Optimism about overall business situation – Key sectors



paid to the health of the commercial sector. However it is slowing revenue growth that remains a greater concern. Almost every driver of financial services revenues seems to be deteriorating, with property values, the credit cycle, equity prices, inflation rates and consumer confidence all moving in the wrong direction.

Underpinning everything is the slowing economy, which is cooling so fast that growth estimates for 2009 have more than halved since June, according to The Economist¹. In a worrying sign that the slowdown is becoming more entrenched, the downturn in commercial business

first reported in June again emerges as a key feature of the current survey.

Cost cutting plans grow more focused on headcount

The industry's assessment of how long financial market disruption will last continues to become more pessimistic. No fewer than 99% of respondents now expect abnormal conditions to persist for more than six months, implying that disruption will persist well into 2009. Profitability is coming under intense pressure, with aggregate figures for the industry the most negative ever recorded by the survey.

Financial services companies are now taking decisive action in response to their operating environment. Most notable is the sharp deterioration in the outlook for employment. Many key sub-sectors expect to see staffing levels fall before the year end, and the overall expectation is the most negative since 1995. Compliance spending continues to climb, albeit at a slower rate.

¹ 'Output, prices and jobs', The Economist – 07.06.08 & 06.09.08

Building societies' confidence may have pulled back from its lowest ebb, but sentiment remains negative and the sector faces a marked downturn in business activity.

Banking

Banking sentiment remains strongly negative, as the sector faces up to growing credit impairments, slowing revenues and higher funding costs. A key challenge for the banks will be how to develop new revenue streams in a world of slowing lending growth.

The recent extraordinary events in the banking market emphasise that banking depends on confidence. Although the survey was conducted before these events the strongly negative sentiment demonstrates the industry's mood was already fragile.

Banking sector sentiment has deteriorated further, and in the past six months has been more depressed than at any other time since 1998. The banks also give their most downbeat prediction for profitability in nineteen years, underpinned by two key concerns. The first – and most immediate – is the continuing threat of credit impairments. As the impact of the credit crunch spreads into the wider economy, non-performing lending is rising while further write-downs of structured transactions remain a real concern. In particular, UK commercial loans are being closely watched for any signs that could herald a shift in the corporate credit cycle.

The second factor affecting profitability is slowing revenue streams. The banks report the worst quarter for business volumes since 1991, reflecting the rapidly cooling economy and their continuing funding constraints. Business with all customer segments has declined for the second quarter running, showing that June's commercial slowdown was no fluke and casting further doubt on the health of the UK economy.

In response to these threats, the banks are increasing their focus on costs. Marketing spending and capital investment are being cut back strongly, and more than half of respondents now expect to employ fewer staff by the end of the year. The banks increasingly see higher funding costs as a permanent feature of their environment, although the actual impact continues to vary depending on the perceived strength of individual banks' balance sheets. Encouragingly, the banks report an increase in average spreads for the third consecutive quarter, as reduced competition enables them to re-price new lending.

Building societies

The societies' ability to generate revenues is being increasingly challenged by factors beyond their control. Some may wish to reassess what levels of profitability they believe they can achieve through the economic cycle.

Building societies' confidence may have pulled back from its lowest ebb, but sentiment remains negative and the sector faces a marked downturn in business activity. The societies face similar challenges to the banks, but their dependence on the UK mortgage market and limited access to capital give them much less room for manoeuvre than their larger cousins.

Building societies face several threats to their revenue streams. Firstly, new mortgage volumes are exceptionally low and unlikely to revive while UK house prices are falling at annual rates of 10% or more². Secondly, margins are coming under increasing pressure as competition for savings strengthens, and improving the pricing of mortgage portfolios remains difficult. Thirdly, maintaining

² 'House prices continue to fall in August', Nationwide – 28.08.08; 'Halifax house price index', HBOS plc – 04.09.08

higher levels of liquid resources is reducing the societies' returns. If there is any optimism to be found, it is in the small balance statistic predicting a recovery in retail demand. This could reflect hopes that the stamp duty holiday announced at the very end of the survey period will stimulate new housing transactions³.

Top-line pressure is compounded by the worsening credit outlook. A balance statistic of +79% predict further growth in non-performing loans, as borrowers are squeezed by higher payments and lower disposable income. The threat of falling profitability is putting consolidation of the marketplace back on the agenda, and also explains why the usually cautious societies are planning their first headcount reductions for six years. On a more positive note, the ability to raise funds is seen as a limitation on business by 57% of respondents, compared to a unanimous view in the previous survey.

General insurance

General insurance rates continue to soften, owing to competition and the downward trend in business volumes as the economy cools. Respondents predict headcount will fall by the end of the year.

After reporting a marked downturn in sentiment in June, a balance statistic of -43% of general insurers retain a negative outlook. Volumes of business continue to decline, and the tight pricing of commercial lines is spreading into the personal market as the insurance cycle accelerates downward. The sector is facing increasing pressure on profitability, and respondents predict that headcount will fall by the end of the year as firms actively review their

cost structures. Insurance brokers confirm this gloomy perspective, reaching new levels of pessimism in their own outlook and taking an even more negative view of customer demand than the insurers themselves.

The sector's weaker performance is not just about premiums, and as time goes by insurers may begin to feel further effects from the credit crunch. For instance, some insurers may yet be affected by provisioning requirements stemming from credit-related shareholder actions. There are unknowns too on the asset side of the sector's balance sheets. Insurers have traditionally benefitted from investment returns bolstering the performance of the underwriting side of their business. They now face a trend of falling investment income, and supplementary questions show increasing concern about the potential impact of write-downs on financial performance.

Life insurance

Despite challenging market conditions, life insurers are feeling slightly more sanguine about their prospects. However, falling profitability and continuing market volatility suggest that the sector will need to keep a close watch on capital levels.

Life insurers' sentiment has worsened slightly compared to three months ago. None of the factors which worried respondents during the first half of the year have gone away. Falling house prices and volatile investment markets continue to curtail customer demand, and a balance statistic of -87% report further weakening in new business. There is a glimmer of light however, with the decline in revenues expected to slow in the coming quarter. It may

³ 'Stamp duty holiday unveiled',
Financial Times – 03.09.08

be this which accounts for the sector's more stable outlook.

The sector continues react to the current environment by tightening its belt. Staff reductions are becoming a dominant theme, with almost all respondents reporting falling levels of headcount. Further reductions are predicted for the coming quarter, in the strongest such response for several years.

The life companies' opinions on recent financial market disruption are revealing. They take similar views to other sectors of the length and severity of the downturn, but no longer see revenue growth as the greatest threat arising from it. Instead they are becoming more concerned about the risk of asset devaluations. This seems another surprising response, given that UK life companies' internal controls and regulatory supervision have generally steered them away from the most risky asset classes. With profitability reported to have fallen for the third quarter running, this result reflects concern that pressure on regulatory capital ratios is unlikely to ease until stock market values improve significantly.

Securities trading

Securities traders' downbeat predictions have been justified by events. Setting an appropriate level of costs and staffing is emerging as a key challenge for the sector.

Securities traders are overwhelmingly negative in their outlook. The numerous market interventions by governments and central banks since the start of the credit crunch have yet to deliver any lasting improvements in stability. If there had been any hopes for a quick recovery in the previous survey, they have vanished.

Levels of business with financial institutions were a disappointment, suggesting that concerns over counterparty creditworthiness persisted into the survey period. This may be exacerbated by market events surrounding Lehmans⁴, although in contrast the US government's decision to support Fannie Mae and Freddie Mac⁵ and the proposed Bank of America takeover of Merrill Lynch⁶ could bring some improvement. It is notable that traders are now predicting tighter spreads.

The sector presents a strikingly negative picture of business volumes, commission income and trading performance. Although the recent volatility of equity and commodity prices may have helped traders in many areas, activity across fixed income remains subdued while investment banking continues to be affected by reduced access to funding. Leveraged buy-outs have fallen significantly, along with the market capitalisation of entities which might have been targets. Some deals are taking place, not least among financial firms divesting non-core activities, but competition for mandates is fierce. Market instability is also making it much harder to price and book-build IPOs and other placements of new capital.

In this environment it is no surprise that respondents' profitability predictions are at their weakest level since the emerging markets crisis of 1997/98. Cutbacks in marketing expenditure and IT investment are accelerating. So are plans for headcount reduction, although securities houses remain reluctant to cut staffing too aggressively.

⁴ 'Lehman Brothers files for bankruptcy', Financial Times – 15.09.08

⁵ 'US takes control of Fannie and Freddie', Financial Times – 08.09.08

⁶ 'BofA to buy Merrill Lynch for \$50bn', Financial Times – 14.09.08

Fund management

Fund managers' sentiment has plunged, as they face up to falling asset prices and net fund outflows across all customer segments. The sector needs to consider how it can profit from increasing levels of risk aversion among investors.

Having been surprisingly upbeat in the previous survey, fund managers now feel uniformly pessimistic about their business situation. Customer activity has undergone a dramatic downturn, with the balance statistic for business volumes swinging from +93% in June to -100% in the current survey.

Fund managers report negative trends in business with retail, institutional and overseas customers. Considering the persistent volatility of share prices, customer caution is hardly a surprise. The picture is corroborated by the IMA's fund flow statistics for July⁷, which show net outflows of £1.9bn among UK institutional customers and £492m from retail funds during the month. Even the new overseas business which was such a positive feature of the last survey's results is now reported to have stagnated.

This finding is also supported by IMA statistics, which show that almost 2% of overseas domiciled funds under UK management were withdrawn during July alone.

Some respondents are predicting a recovery in overseas demand before the year end, but this looks very optimistic; emerging market investors are increasingly wary of developed equity markets and European investors are rapidly shifting towards cash. This is particularly relevant when the recent market volatility connected with events surrounding Lehmans is taken into account.

The growing popularity of money funds puts further pressure on the sector's revenues, since they generate relatively low fees.

Fund managers are becoming increasingly resigned to a long downturn, and are responding accordingly. The sector has no plans to increase its marketing expenditure over the coming year, and plans to reduce its headcount for the first time in fifteen quarters. The only area expected to enjoy increased spending is compliance, where fund managers face an ongoing flow of new regulation.

About this survey

The survey was carried out between 20th August and 3rd September 2008. A total of 100 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).

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Useful Contacts

To discuss the implications for the various sectors, please speak to your usual PricewaterhouseCoopers contact or one of the following:

Financial Services

Chris Jones

UK Financial Services Leader
020 7804 2393
chris.p.jones@uk.pwc.com

Banking

John Hitchins

020 7804 2497
john.hitchins@uk.pwc.com

Andrew Gray

020 7804 3431
agray@uk.pwc.com

Building Societies

Mark Hannam

0113 289 4307
mark.a.hannam@uk.pwc.com

Capital Markets

Mark Batten

020 7804 3169
mark.e.batten@uk.pwc.com

James Worsnip

020 7804 9635
james.c.worsnip@uk.pwc.com

Fund Management

Pars Purewal

020 7212 4738
pars.s.purewal@uk.pwc.com

Rob Mellor

020 7804 1385
robert.mellor@uk.pwc.com

Insurance

Andrew Kail

020 7212 5193
andrew.kail@uk.pwc.com

Gavin Phillips

020 7804 9988
gavin.phillips@uk.pwc.com

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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Max Harmer
PricewaterhouseCoopers
10 – 18 Union Street
London SE1 1SZ
or send an email to: max.j.harmer@uk.pwc.com

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