

Financial services survey

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

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Executive summary

The 81st CBI/PricewaterhouseCoopers financial services survey shows continuing improvement in sentiment. However, short-term prospects are weaker than had been expected, suggesting that the recovery in activity will be slow. Cost reduction remains a dominant theme, although marketing plans have started to increase. The impact of the financial crisis on the UK industry's competitiveness is a growing concern.

Confidence increases, but the short-term outlook is far from encouraging

The survey shows financial services sentiment continuing to improve, but the industry as a whole remains uncertain whether its glass is half-full or half-empty. On the upside, there is no doubt that confidence and business prospects improved during 2009. Overall volumes of business are also reported to have grown, albeit by a very small balance statistic, for the second quarter running (see Figure 1).

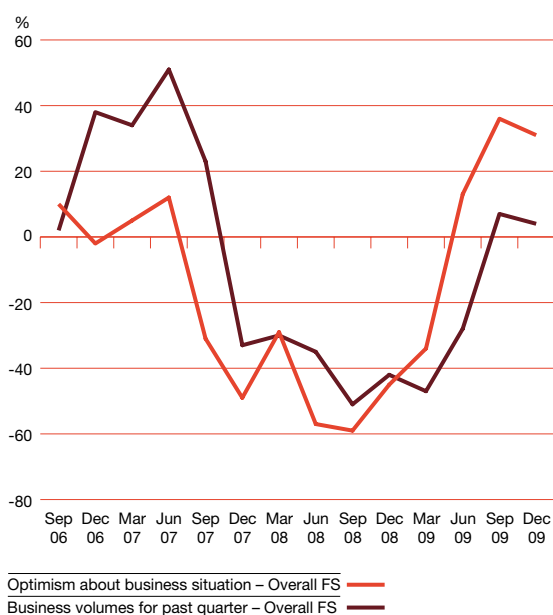
However, even if headline confidence is increasing it is also clear that short-term prospects are less encouraging, with aggregate forecasts for volumes and revenues pointing firmly to the

downside. The consensus view for the UK economy may point to a return to growth in 2010¹, but responses to the survey imply that any recovery is likely to be hesitant and that it will take time for the positive effects of this growth to make themselves felt in financial services.

Uncertainty about demand is keeping costs under pressure, but marketing bucks the trend

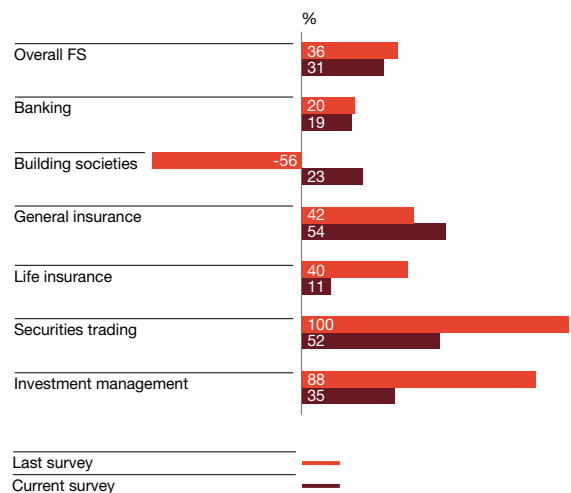
The main subsectors of financial services are more uniformly optimistic than at any time since the financial crisis began (see Figure 2). All the same, several are concerned about the outlook for income as they enter 2010, and predictions for customer demand do not inspire a great deal of confidence. Banks and general insurers are particularly downbeat about their revenue prospects, and the responses of building societies, life insurers

Figure 1: Optimism and business volumes



Source: CBI/PricewaterhouseCoopers Financial services survey, December 2009

Figure 2: Optimism about overall business situation – Key sectors



Source: CBI/PricewaterhouseCoopers Financial services survey, December 2009

¹ 'Forecast for the UK economy: A comparison of independent forecasts', HM Treasury, 09.12.09

and securities traders are best described as mixed. Investment management is the only major subsector predicting growth in revenues and customer demand. Lenders expect non-performing loans to continue growing, although the rate of acceleration appears to be slowing.

Uncertainty about demand means that expense reduction remains a key priority in almost all corners of the industry. On an aggregate basis, commitment to cost cutting is as strong as it has been in the survey's 20-year history, and growth plans remain heavily biased towards existing customers. Nonetheless, it is notable that headcount levels are seen as having stabilised after several quarters of concerted reductions. The industry also intends to increase its marketing spending, and product development is attracting more attention than at any time in the past year.

UK financial services competitiveness is an increasing concern

Regulation is an understandably strong concern for many respondents, given the current climate of political hostility towards the industry. With this in mind, it is interesting that a supplementary

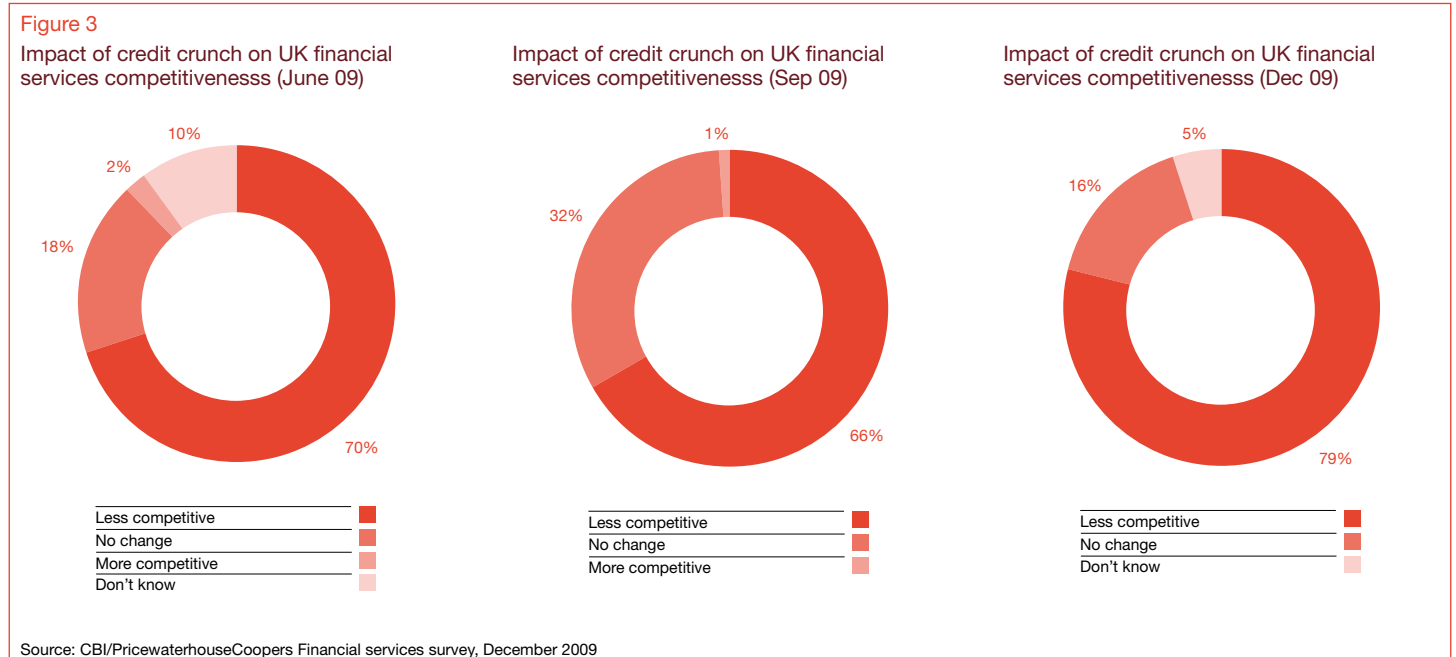
question to the survey shows increasing disquiet about UK financial services competitiveness (see Figure 3). While the survey was conducted before the Chancellor's announcement of the banking bonus tax, this reflects a perception that the UK is imposing tougher responses to the financial crisis on the industry than many other countries appear to be doing. On this measure, conviction that London's stature as a financial centre has been damaged by the crisis seems to be growing.

Twenty years young

To mark twenty years of this survey, the CBI and PricewaterhouseCoopers have produced "Twenty Twenty Vision", a unique one-off publication.

This report offers a retrospective view of the survey's eventful first twenty years. It also provides a potential vision of what the next twenty years might hold for the industry, drawing on interviews with twenty leading City figures.

"Twenty Twenty Vision" will be launched on 20 January 2010.



Banking

The banks remain confident, but short-term prospects are disappointingly weak. Cost control remains a key focus and regulation is a serious concern. However, there are some signs of optimism about the medium-term outlook, with headcount on the rise and a growing interest in new products.

Banking confidence has increased for the second quarter running, a welcome rally after two years of downbeat responses. As predicted, volumes of business and levels of income are reported to have grown. Unfortunately the outlook is less encouraging as activity and revenues are expected to decline over the coming quarter, and predictions for demand remain weak. Lower anticipated activity with commercial and financial customers suggests that the real economy is barely out of recession, and negative predictions for retail demand imply that the economic recovery is likely to be tentative.

Considering these headwinds, the banks' increasing confidence probably reflects hope for a brighter medium-term outlook. Respondents are not entirely downbeat and do reveal several signs of optimism: first, a positive balance statistic report growing headcount for the first time in two years: second, there is increasing interest in developing and launching new products: third – and not for the first time since the crisis began – the banks have managed to increase their average spreads. This reflects their ability to reprice loans as they mature, and may also indicate a slight reduction in wholesale funding costs.

Nonetheless, the banks temper their growing confidence with caution. The sector continues to cut its cost base and non-performing loans are still predicted to grow, although responses suggest this may begin to slow. Regulation is also a major concern. The sector faces a plethora of potential compliance requirements and remains very uncertain as to the final shape of future regulation.

Building societies

Building societies are enjoying a sharp upswing in sentiment, with levels of business and average spreads expected to stabilise. The sector is planning to increase its marketing spending, but it is too soon to say that a recovery is underway.

Building societies report their most decisive improvement in sentiment since the heady days of early 2006. At first glance it is hard to see why, since business volumes are reported to have fallen for the sixth consecutive quarter. However, the balance of responses is less negative than it has been, and predictions for the coming quarter are evenly balanced. More significantly, average spreads are reported to have stabilised after a year of emphatic decline. This is particularly notable given the tough competition for retail deposits, not just among the societies but also from banks and NS&I², and probably reflects some repricing of back book mortgages onto standard variable rates.

Could building societies finally be calling the bottom of the downturn? If so, it would be very welcome news for the battered sector. It is certainly striking that a balance statistic of +68% are planning to increase marketing spending. Encouraged by rising average house prices³, growth plans are focused on acquiring new customers and making use of advertising. The headcount reductions reported by most respondents over the past year also appear to have been put on hold.

Nonetheless, it is worth sounding a note of caution. There is no sign as yet of any recovery in customer demand, and while profitability may have stabilised it is not expected to increase. Non-performing loans continue to climb, driven by an overhang of commercial mortgages, although in common with the Council of Mortgage Lenders,⁴ respondents expect arrears to level off. Lastly, there is increasing weariness over the potential burden of further regulation. In addition to the ongoing requirements of Treating Customers Fairly, the societies continue to face supervisory pressure to carry more capital and hold more liquid assets.

2 'Nationwide lashes out at rescued banks', Financial Times, 20.11.09

3 'House prices edge up further in November', Nationwide, 01.12.09

4 'CML cuts 2009 repossession forecast', Council of Mortgage Lenders, 12.11.09

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.

General insurance

General insurers remain optimistic, despite a mixed set of survey results. The sector seems to have enjoyed strong demand during the quarter, but the outlook for pricing is challenging. Profitability is coming under further pressure and there is a resultant focus on reducing operating costs.

General insurers remain in a relatively confident mood, and feel optimistic about their business situation for the fifth quarter in a row. Respondents have seen strong demand from retail, commercial and financial customers during the quarter. It must be this positive picture that is sustaining insurers’ confidence, since most of their other responses are far less encouraging. Most notably, levels of premium income continue to feel the pressure of strong competition and the majority of insurers are struggling to make rating increases stick. This is true across most classes of risk, and is a particular concern given that almost all respondents see investment income following a downward path.

Against this backdrop, it is not surprising that profitability is coming under renewed pressure. Furthermore, market conditions suggest that the sector is likely to have a more difficult year in 2010. The cost of claims, which has remained manageable during 2009, represent a potential downside risk; investment returns look unlikely to improve during the year ahead; and there is little current expectation that rates in most lines will harden during 2010. This anecdotal impression is supported by the survey, which shows that 97% of respondents are concerned about levels of demand during the year ahead, driven by heightened competition.

In response to this outlook, insurers report a renewed enthusiasm for cost reduction. More than three-quarters are cutting operating expenses and just as many plan to reduce headcount, the most marked response of its kind since 2003. Marketing investment intentions also reached a six-year low, with almost 90% of respondents expecting to cut back in this area. It is also surprising to note the sector’s apparently low investment in regulatory compliance. Given the focus of many insurers on meeting the requirements of Solvency II, this looks like an unlikely outcome.

Life insurance

Life insurers remain optimistic – just – even though demand for their core products is stubbornly weak. Profitability continues to come under intense pressure and most respondents predict staffing reductions. The sector is hoping to capitalise on any future recovery in demand.

Life insurers report a further slight increase in optimism, although it is far less marked than in the previous two quarters. As has been the case throughout 2009, confidence appears more based on hope than reality. Demand for the sector’s core investment and protection products remains weak, with customer activity seen as having declined across retail and wholesale categories. Volumes of business were reported to have fallen by almost three quarters of respondents, the ninth successive decline recorded by the survey.

Life companies are not only facing persistently weak customer demand, they are consistently disappointed with their own financial performance. For the fifth quarter running, profitability is reported to have declined by more respondents than expected. In consequence, a strong focus on cost reduction continues to hold sway, and a balance statistic of -83% expect staffing levels to fall further in the coming quarter. Unfortunately, the costs of compliance are expected to buck this trend, as the sector focuses on Solvency II implementation and other regulatory challenges. Add to this the prospect of IFRS Phase II for insurance contracts,⁵ and it is easy to see why all respondents are concerned about the impact of regulation on their business.

Why then the continued optimism among life insurers? The sector seems to be pinning its hopes on environmental factors, such as the nascent recovery in average house prices⁶ and the continuing rally in equity markets. A small positive balance of respondents see new business improving, and it should also be noted that almost 90% expect to spend more on marketing during 2010 – a huge upswing from the previous survey. When it comes to plans for organic growth, life companies are heavily focused on retaining and cross-selling to existing customers. The sector is positioning itself to capitalise on any increase in demand when the market for its core products finally improves.

⁵ ‘Making sense of the numbers’, PricewaterhouseCoopers, November 2009
⁶ ‘House prices edge up further in November’, Nationwide, 01.12.09

Securities trading

Securities traders continue to feel more confident, but are taking a measured view of their business prospects. The short-term outlook for revenues is muted, and though there are signs of a fresh drive to recruit new customers, the sector's optimism remains tinged with caution.

Securities traders continue the run of confidence that started in June. However, their optimism is more grounded than at the last survey, when equity markets were rallying fast and confidence was sky-high. The sector is returning to a more realistic outlook, with other responses suggesting that the boom that began in the summer and continued through the autumn might come to an end as we enter 2010. Driven by retail activity, business volumes are reported to have increased, but not perhaps as fast as many had predicted. More tellingly, trading income is seen as having fallen and a balance statistic of -87% expect further declines. Fees and commissions also failed to live up to their high expectations, and are not expected to pick up anytime soon. This overall caution seems to be slightly at odds with the optimism being generated by those who talk of a strong pipeline for M&A and IPO activity in the early part of 2010, so there may be scope for improvement in this area.

Securities traders' other responses to the survey are similarly mixed. A small balance of respondents report an increase in profitability, but almost half now expect this to be reversed in the coming months. From a positive standpoint there has been a strong, unexpected pickup in headcount, with the focus of recruitment apparently on sales and distribution. All respondents are aiming to acquire new domestic customers, and marketing intentions reached their strongest level since 2005.

Even so there is a clear sense that securities traders, while far more optimistic than a year ago, remain essentially cautious. Concerns about future levels of demand remain strong, and the debt standstill requested by Dubai World⁷ during the survey period is a reminder of the potential for further financial shocks and their capacity to unsettle securities markets.

Investment management

Investment managers continue to take confidence from the recovery in equity markets, and are enjoying a resurgence in customer demand. As the stress on managers' business models declines, so too does their interest in reducing expenses. Instead, costs are growing as the sector focuses on business development.

Investment managers' confidence continues to increase, albeit at a slower rate than during the two previous quarters. The sector is enjoying a welcome period of stability, with the performance of equity markets during 2009 apparently encouraging investors to re-enter the market. Demand from institutional, retail and overseas customers is seen as having increased during the quarter, and almost two-thirds of respondents expect retail and foreign activity to strengthen further. As a result, volumes of business are reported to have grown and fee income is expanding. Most of this revenue growth is dropping to the bottom line, with a balance statistic of +67% reporting an increase in profitability during the quarter.

With revenues on the rise, the sector is allowing operating expenses to expand too. Headcount is increasing as well, suggesting that the staffing additions reported in the last survey were no fluke. On this evidence, it appears that the cost-cutting agenda that dominated the thoughts of many investment managers in early 2009 may be losing some of its impetus.

Instead, investment managers are increasingly focused on developing new products. In the short term, respondents are hoping to increase cross-sell to existing customers, which emerges as the sector's key priority for organic growth. As highlighted by participants at PricewaterhouseCoopers' recent European Asset Management Executive Forum,⁸ the potential appeal of UCITS IV products also offers investment managers the opportunity to broaden their overseas distribution, particularly in Asia. In the longer term, UCITS IV holds out the possibility of reducing costs by centralising the management and administration of funds at a pan-European level.

⁷ 'Dubai shock after debt standstill call', Financial Times, 25.11.09

⁸ 'European AM Executive Forum 2009 – Voting Pad Results Summary', PricewaterhouseCoopers, 17.11.09

About this survey

This survey was carried out between the 18th November and 2nd December. A total of 83 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).

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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 is £210 and for non-members is £360.

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