

Financial services survey

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

March 2009 • Number 78



*connectedthinking

PRICEWATERHOUSECOOPERS 

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Executive summary

The 78th CBI/PricewaterhouseCoopers financial services survey suggests the industry is feeling slightly less pessimistic than in December. Even so, trading conditions remain extremely tough. The industry is not only feeling the effects of the recession, it is facing the longer term threat of reduced competitiveness. Overall, employment forecasts are on the down side.

Industry sentiment is falling less rapidly, but remains firmly negative

Financial services sentiment is still deteriorating, but not as quickly as at the end of last year. This slight moderation in pessimism is at odds with the very poor levels of business reported during the quarter, and for the first time since early 2007 these two indicators are moving in different directions (see Figure 1).

Why the change in attitudes? Now that almost two years have passed since the financial crisis began, it may be that firms are adjusting their expectations. Another possible explanation is that the coming quarter could see the decline in business activity begin to slow. General insurers remain positive about their prospects, and several other sub-sectors appear to expect business to stabilise, if not recover,

Figure 1: Optimism and Business Volumes

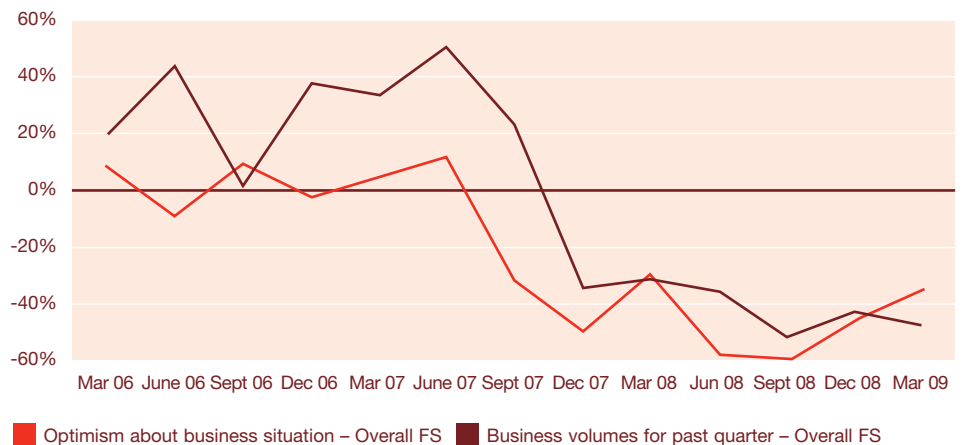
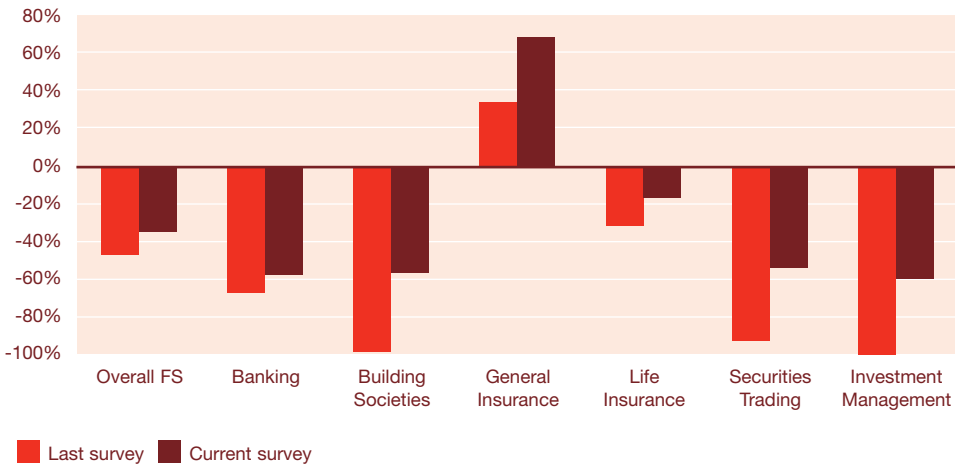


Figure 2: Optimism about overall business situation – Key sectors



in the coming months. It remains to be seen whether this is misplaced optimism.

Each major sub-sector of financial services is less depressed than in December, but almost all retain a negative outlook. The confidence of general insurers is having a distorting effect on aggregate industry sentiment (see Figure 2).

The crisis is seen as having damaged UK competitiveness

The financial crisis is not only affecting individual firms, but also the UK industry's international profile. A new question about the impact of the crisis on UK financial services as a whole revealed that 67% of respondents felt it had left the industry less competitive than before (see Figure 3). This is a striking response. No global financial centre has been untouched by recent events, but at a time when most firms are scaling back their investment plans, the UK industry needs to keep

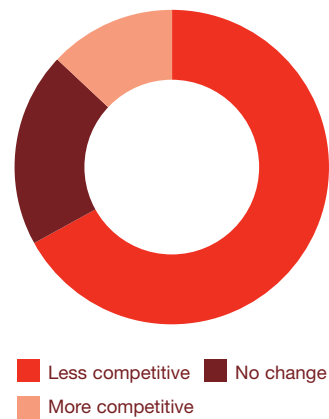
its eye on long-term competitiveness and ensure that it is developing considered and innovative strategies for the future¹.

Economic reality is driving staff reduction plans

Even if the immediate impact of the financial crisis may be easing in some respects, there is no disguising the fact that the UK is entering a severe recession. Economic growth forecasts continue to be revised downwards at remarkable speed. One bank's estimate of UK GDP growth in 2009 has moved from -1.6% to -2.5% in less than three months².

Increasing unemployment, falling house prices, volatile stock markets and very low base rates have negative implications for the top and bottom lines of most sectors of financial services. Households are trying to reduce their levels of gearing, demand for investment-related products is understandably weak and non-performing loans

Figure 3: Impact of Credit Crunch on UK Financial Services Competitiveness



continue to climb against a backdrop of falling asset values.

This reality is acknowledged in the industry's employment outlook, which is frankly bleak. General insurers are planning to employ more staff but banks, building societies, life companies and investment managers all expect headcount to fall. Marketing intentions are also strikingly negative, with many sectors preferring to focus on retaining existing customers.

¹ 'The day after tomorrow' – From survival mode to sustainable strategy, PricewaterhouseCoopers, 02.09.

² 'Economic Review', HSBC Bank plc – Issues 50 and 51, 30.10.08 and 15.01.09.

Banking

Banking performance remains under pressure, although some respondents now expect business to stabilise in the coming quarter. Even so, the worsening slowdown casts a shadow over the sector's outlook.

Banking sentiment remains pessimistic, but while revenues and business volumes are declining there is cautious hope that they may stabilise in the coming quarter. Some respondents even think customer demand could pick up slightly during the next three months. However, the conflicting pressures acting on the sector make this a tricky area to gauge. At the same time that the government is encouraging banks to sustain or increase levels of lending, investors and the FSA are urging them to be more cautious³. Credit is still available to households and businesses with good risk profiles, but falling house prices and rising unemployment mean retail demand is weak. Most households would prefer to reduce leverage or increase savings than take on new debt.

A small balance of respondents predicts stronger profitability for the coming quarter. This reflects the modest underlying profitability of most new business and, for banks with capital markets activities, a stronger start to 2009 compared to the end of last year.

Nonetheless, there is no escaping the ongoing climb in the value of non-performing loans, in both the retail

and corporate arenas. Even if banks can draw a line under their sub-prime exposure, they still face a deep and potentially protracted recession. The sector remains focused on reducing operating expenses, headcount, capital expenditure and marketing. It is also notable that the widening of spreads seen during 2008 has halted. This reflects the limiting effects of very low base rates, and reminds the banks that the year ahead is likely to be challenging.

Building societies

Building societies are under pressure from all sides. They face lower demand, tighter margins and growing impairments. In response the sector is developing a stronger focus on cost control.

Building societies' sentiment remains firmly in negative territory, although the rate of decline has softened since December. Several societies announced losses soon before the survey was conducted, and the slight improvement in mood may indicate relief that regulators, members and the media made a relatively muted response to those announcements.

Even so, the sector's assessments of business volumes, revenues and profitability make for grim reading. The societies are facing a devastating combination of threats. First, all respondents agree that non-performing loans have grown since the year-end and will continue to climb. The ongoing falls in average house prices – quantified by both

³ 'The day after tomorrow' – Government inside the tent, PricewaterhouseCoopers, 02.09.

Halifax and Nationwide at nearly 18% year-on-year⁴ – underpins the severity of the problem. Second, customer demand remains extremely low and shows no sign of picking up. When asked about their strategy for the coming quarter, 97% of societies said they expected no growth at all, and the sector has effectively abandoned its marketing plans. Third, the societies' margins are under intense pressure as the very low interest rate environment erodes the attractiveness of deposits to savers.

The macroeconomic outlook does not offer the sector much cause for optimism. An environment of exceptionally low base rates and climbing unemployment suggests that 2009 could easily be tougher than 2008. In response, the sector is developing a new commitment to cost control. Marketing and other non-essential spending is being cut back and 97% of respondents expect to make further staff reductions during the coming quarter.

General insurance

General insurers are increasingly optimistic about the impact of harder premium rates on underwriting profitability. Uniquely in financial services, the sector is planning to increase its headcount.

General insurers feel more optimistic than they did in December, and are more confident than at any point since 2005. The sector's mood is positively euphoric in comparison to

other areas of financial services. This may seem surprising, given insurers' poor investment returns during 2008, but this cloud has a solid silver lining. The reduction in investment return is a key driver in pushing insurers to increase premium rates. The anticipated improvement in underwriting profitability underpins the sector's newly positive outlook.

This process was first predicted in the last survey bulletin, and now appears to be underway. The value of premium income is reported to have increased for the first time in six quarters, and a balance statistic of +60% expect further expansion in the next three months. Demand for general insurance is not greatly affected by the economic cycle, and business is expected to continue growing across personal and commercial lines. New customers are seen as the most promising source of growth, reflecting the increasing commoditisation of general insurance – even in the commercial sphere – and the market's high rates of churn.

Claims are increasing at a manageable pace, although the negative effects of the economic downturn may take several quarters to emerge fully. Nonetheless, the anticipated improvements in pricing have put profitability on an upward trend for the first time in a year. Operating costs are being kept under control, and this is the only sub-sector of the industry making plans for recruitment.

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⁴ 'Halifax House Price Index', Lloyds Banking Group, 05.02.09; 'House Prices', Nationwide Building Society, 26.02.09.

Life insurance

Life insurers are facing exceptionally low levels of new business and overall profitability. The sector's twin areas of focus are now reducing costs and retaining customers.

Overall sentiment among life insurers is deteriorating more slowly than before, but heavy falls in life companies' share prices since the survey was conducted may have reversed this moderation. Investors' concerns about the sector stem from firms' varying estimates of their potential exposure to corporate default risk. Even leaving balance sheet risk aside, the survey overflows with downbeat responses. Revenue trends are strongly negative, and the value of new business during the quarter is reported to have fallen by a balance statistic of -95%, the weakest such figure in twenty years of survey data. When asked to assess customer activity, almost all respondents see commercial, retail and overseas demand following a downward trend. This despondent view reflects a hostile operating environment, with falling stock markets and house prices undermining demand for the industry's core investment and protection products.

The recent vagaries of equity markets do not only discourage customers, they also have an effect on life companies' own capital positions.

With the FTSE 100 index at levels not seen since early 2003⁵ the sector is feeling sensitive to regulatory sentiment, not just investor scrutiny. Almost all respondents report falling profitability, and more than three quarters are committed to reducing their operating costs. A balance statistic of -84% expect headcount to fall during the next quarter, and there is a similar commitment to cut marketing expenditure and long-term investment. Instead, life companies are focusing all their effort on reassuring and retaining their existing customers.

Securities trading

Securities traders may be slightly less pessimistic than before, but the downturn in hedge fund activity continues to make its mark. Respondents are surprisingly equivocal on the need for cost cutting.

Securities traders are feeling less pessimistic than at the last quarter, but sentiment remains firmly downbeat. Volumes of business are reported to have fallen for the sixth consecutive quarter, and commission income has also declined. Surprisingly, respondents take a more balanced view about the outlook for business in the coming quarter, suggesting that activity levels may stabilise during the spring.

Even if that proves to be true, stabilisation is not the same as recovery. Many financial markets remain highly illiquid and securities

traders' absolute levels of activity are far lower than during the bull market. True, spreads are reported to have tightened for the first time since 2007, reflecting relatively buoyant trading volumes on the major equity, government bond and interest rate swap markets. However customer activity with financial institutions continues to fall, even if the decline is slower than in the hectic days of last autumn. This reflects the rapid drop off in hedge fund activity, which until recently had been a crucial source of investment banking revenue. Hedge funds continue to face redemption and margin pressures, forcing them to trade less and hold large cash balances. The rapid decline in re-hypothecation is also placing a further brake on trading by reducing the availability and affordability of leverage. Many hedge funds remain wary of lodging securities with their prime brokers.

Securities traders are not just suffering from the cooling of secondary markets. The broader economic slowdown is depressing primary issuance – even if secondary fundraising is more buoyant – and the sector's principal investments continue to be a source of pain. Profitability remains on a downward track, so it is surprising to find that respondents seem to be taking a balanced view on the future direction of costs and headcount. It remains to be seen how long the sector can sustain such a sanguine attitude.

Investment management

Investment managers are facing a significant reduction in profitability. The sector's fragmented structure suggests good scope for consolidation. Customer retention is a growing priority for many.

Investment managers may not be universally pessimistic about their situation, but they can still find plenty to feel glum about, and further falls in equity indices since the survey was conducted are unlikely to have improved their mood. All those responding consider current business to be below normal levels, suggesting it may be time for the sector to reassess its notions of normality. There is some good news; customer activity appears to have levelled off after several quarters of declining demand. This response tallies with the positive net fund flows – in retail and institutional categories – reported by the IMA for January⁶. Even so, one swallow does not make a summer and this looks more like a temporary effect than a return to sustainable net inflows. Customer demand is seen as a critical concern and the primary barrier to growth during the year ahead.

The sector does not just face weak demand; profitability is falling fast too. Investors continue to reduce their risk appetite, shifting from higher margin assets into cash and other secure products, and all respondents expect profitability to fall in the coming quarter. The scope for consolidation is obvious, and the sector could experience significant M&A activity during the year if banking groups divest captive management arms, stronger houses acquire weaker counterparts and private equity firms take a more active interest in the sector⁷.

The gloomy outlook for profitability is encouraging firms to reduce all non-essential expenditure. Where money is being spent, it is strongly focused on customer retention; a balance statistic of +96% see existing customers as an important source of growth. After a surprising uptick in December, headcount forecasts are back in negative territory. Increasing efficiency remains the primary motive for capital investment, although the requirements of regulation mean that compliance spending seems to be unaffected by the downturn.

About this survey

The survey was carried out between 18th February and 4th March 2009. A total of 90 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).

⁶ 'Investment Fund Statistics January 2009', Investment Management Association, 27.02.09.

⁷ 'Back to the "domestic" future', PricewaterhouseCoopers, 03.09.

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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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