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Industry sentiment

Financial Services Survey

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

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The 85th CBI/PwC Financial Services Survey shows a picture of continuing recovery in sentiment and volumes of business, even if activity remains below normal levels.

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Executive summary

The 85th CBI/PwC Financial Services Survey shows a picture of continuing recovery in sentiment and volumes of business, even if activity remains below normal levels. Most sub-sectors of the industry report encouraging top-line performance, and some are allowing costs to rise. There are mixed views over employment levels and investment is declining, although many firms are spending on regulatory compliance. The medium-term outlook remains tinged with caution.

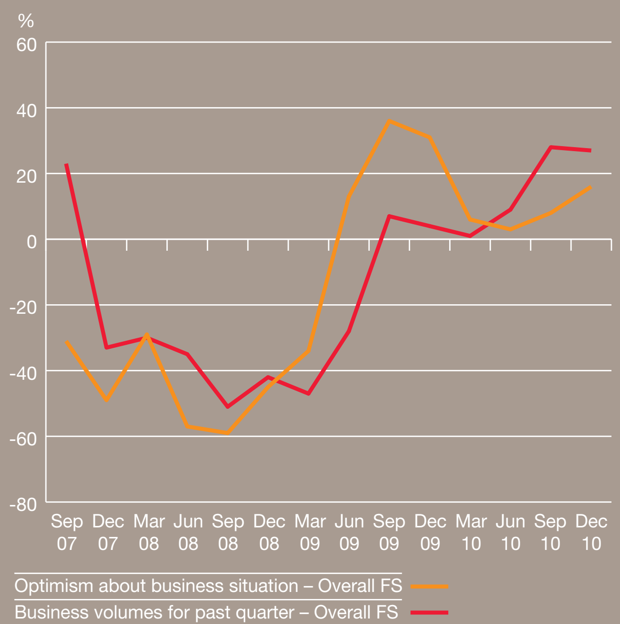
Volumes of business continue to pick up at a faster rate than earlier in the recovery

The survey shows a further improvement in UK financial services sentiment, which has now been moving upwards for 18 months. Aggregate growth in volumes of business remains solid (see Figure 1), very much in line with last quarter's prediction. This suggests that activity is continuing to pick up after a very hesitant early recovery during the latter part of 2009 and the early months of 2010.

The majority of financial services sub-sectors have shared in this increasing activity, and predict further growth early next year (see Figure 2). Two important exceptions are the banks and building societies, where weak retail demand is expected to lead to subdued activity. However, in the case of the banks this cautious view is partly offset by the outlook for commercial demand, which is expected to pick up in the coming quarter.

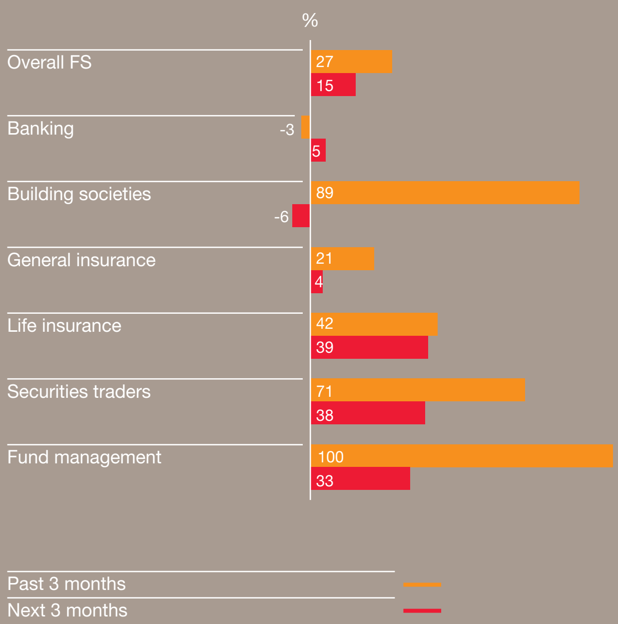
Overall, the slow but steady improvement in the industry's survey responses is consistent with the improving outlook for the UK economy. Forecasts from independent economists and the Office for Budget Responsibility suggest that 2011 will see an improvement in GDP growth, although consumer spending is still expected to lag behind the wider economy.[1]

Figure 1: Optimism and business volumes



Source: CBI/PwC Financial Services Survey, December 2010.

Figure 2: Trends in volume of business



Source: CBI/PwC Financial Services Survey, December 2010.

The focus on costs is easing slightly, but there is some uncertainty over levels of employment

Although many respondents remain focused on cost control, the gradual pick up in revenues is encouraging more sub-sectors to allow expenses to rise. To be fair, the increasing cost of regulation is a significant driver of expenditure across the industry, with aggregate predictions for compliance spending reaching their highest levels since the end of 2006 when this area was first surveyed.

These issues are linked to the outlook for numbers employed. Aggregate headcount is seen as having fallen during the quarter and further reductions are predicted, even if not all sub-sectors agree that staffing is on a downward trend. These results reflect the fact that while financial services firms are cutting back in some areas, many are recruiting in specialised areas such as compliance and risk management. It will be interesting to see what impact the final version of the Remuneration Code (published after the survey period) will have when it takes effect in the New Year.[2]

Confidence about the medium-term outlook remains tentative

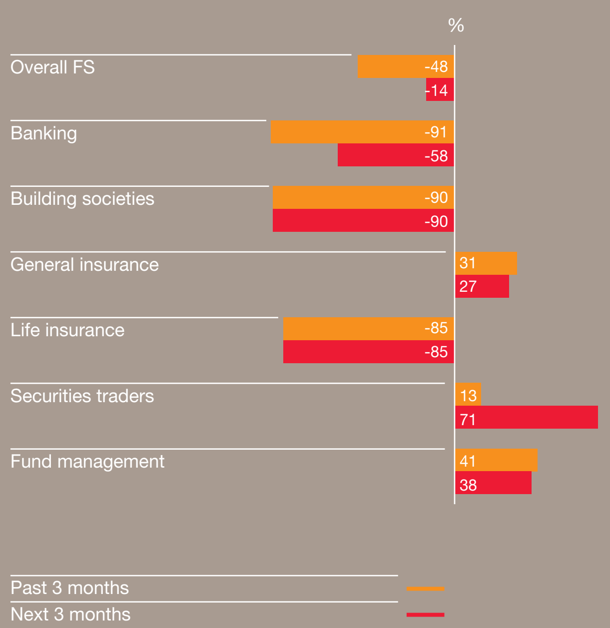
Looking forward, respondents have mixed views about the outlook for business over the next twelve months. On the positive side, impairment levels are expected to continue to fall and aggregate profitability is forecast to remain on an upward track, even if this conceals a degree of variation between sub-sectors. Respondents are also putting more emphasis on developing new products and launching new businesses.

In a less positive vein, marketing plans appear to be softening, regulation remains a major preoccupation for the industry, the ability to raise funds is a growing concern for some sub-sectors and average spreads appear to be coming under fresh pressure. Above all, the fragility of demand is a persistent source of uncertainty.

1 'UK Economic Outlook', PwC, November 2010.

2 'It could have been worse', PwC, 17.12.10.

Figure 3: Numbers employed



Source: CBI/PwC Financial Services Survey, December 2010.

The banks are feeling more confident than at any time since 2005...

Banking

Banking confidence has climbed rapidly, although levels of business remain subdued. Average spreads have stopped expanding and profitability is coming under pressure, but the banks expect commercial demand to pick up in the coming quarter.

The banks are feeling more confident than at any time since 2005, even if income declined during the quarter and the majority still see levels of business as below normal. This contrasting picture is matched by respondents' views of customer activity. Business with retail customers is seen as subdued, reflecting weak new mortgage lending and ongoing debt repayment. Set against this, a balance figure of +63% of respondents predict stronger commercial demand, offering some support for the impression that the UK manufacturing sector is enjoying an economic recovery.[3]

Growth in average spreads has been a feature of banking responses since 2008, but the banks now see this expansion as having come to an abrupt halt. This sudden stabilisation suggests that a period of focus on balance sheet management may have come to an end, allowing a renewed interest in market positioning and the retention of business. Falling activity with financial institutions could also indicate that some banks are heeding the Financial Services Authority's liquidity guidance, by increasing longer-term funding and reducing their reliance on the inter-bank market.

The banks intend to reduce their expense base during the coming quarter, despite the growing costs of regulation. Numbers employed show the strongest reported decline in the survey's history, although actual job losses are unlikely to be as severe as this statistic implies. The banks may be cutting staff in some areas but they are expanding in others, and are engaged in a talent war for specific compliance and risk management skills. The improving economic environment is helping non-performing loans to decline further, although this is not providing much support to profitability. Looking forward, the banks remain preoccupied by weak demand and regulation. Faced with Basel III and an emboldened FSA, almost all are expecting to spend more on compliance during 2011.

3 'UK manufacturing recovery continues', *Financial Times*, 07.12.10.

Building societies

Building societies report another strong quarter of activity. Impairments have begun to fall and profitability is rising. However, average spreads have fallen again and the sector is struggling to raise affordable funds. The societies remain uncertain about their medium-term outlook.

Building societies appear to have had a better quarter than expected, with very high balance statistics reporting higher volumes of business and stronger levels of income. Unfortunately the outlook for business is less encouraging, and the sector's headline sentiment is slightly lower than at the last quarter.

Perhaps of greater concern to the societies is the fact that average spreads have resumed their downward march after several quarters of apparent stabilisation. Almost all respondents now expect to see margins narrow further. This result is closely tied to the sector's concerns about its outlook for the year ahead. The societies see competition and the ability to raise funds as highly likely to limit their business development during 2011, reflecting their continuing difficulties in wholesale funding markets and intense competition from the banks for retail deposits. Against this background, it is hard to understand how the societies can report a second quarter of increasing profitability. The most likely explanation is the reduction in the value of non-performing loans reported by most respondents, although there is little confidence that this trend will continue into the New Year.

Looking ahead, the societies retain their uncertain outlook. Almost all respondents are expecting to reduce headcount in the first quarter of 2011, although this is unlikely to translate into draconian job cuts. There is an apparent spike in IT capital expenditure plans, but it is notable that expanding capacity is not the goal. Instead the aims of investment are to increase efficiency, replace ageing infrastructure and respond to legislation and regulation. The last point is particularly important. Not only is regulation seen as a leading source of uncertainty, it is driving higher spending as the societies respond to the FSA's increasingly assertive approach and consider the impact of Basel III on their model.

Building societies appear to have had a better quarter than expected…

After rising and then stabilising twice over the previous four quarters, general insurers' sentiment has now fallen back.

General insurance

General insurers' volatile sentiment reflects uncertainty over the pricing outlook and concern about the intensity of competition. Rising claims and weak investment returns are putting profitability under pressure, although headcount is reported to be rising.

After rising and then stabilising twice over the previous four quarters, general insurers' sentiment has now fallen back. The volatility of the sector's headline confidence does not indicate any major swings in premium rates or levels of claims. Instead, it points to a lack of certainty over the sector's current business outlook. While some insurers have managed to achieve localised improvements in rates during 2010 – for example in personal motor insurance, where bodily injury claims hurt many firms' profitability in 2009 – the general pricing environment is one of tough competition across both personal and commercial lines. This is borne out by the fact that respondents see premium income failing to keep up with volumes of business. Insurers are hoping the cycle will pick up soon, but there still appears to be excess underwriting capacity in the market. Firms identify competition as the factor most likely to limit their business during the year ahead.

Not only are insurers facing high expense ratios, but the value of claims is seen as having risen for the third quarter running and investment returns are reported to have declined by a balance statistic of -44%. As a result, respondents report a decline in profitability during the quarter. More surprisingly, a small balance statistic expects this trend to reverse during the first quarter of 2011.

The explanation for this may lie in the sector's plans to keep operating costs under tight control. In common with a number of other sub-sectors, insurers expect to spend less on marketing in the year ahead. Even so, numbers employed are reported to have increased for the second quarter running. It is not obvious why firms might be increasing their headcount, although regulatory compliance may be a contributory factor. A large majority of firms are expecting to spend more in this area in 2011.

Life insurance

Life insurers continue to enjoy good levels of customer activity, although the value of new business disappointed. Looking forward, respondents' views are a mixture of the positive and the negative, which serves as a reminder of the increasing diversity of the UK life sector.

Life insurers' headline sentiment has stabilised again after the strong upswing reported in the previous survey. This response appears to reflect some contradictory views of the sector's performance. On one hand, although volumes of business are still reported to be climbing, many respondents feel that activity levels remain below normal. Perhaps more importantly, the survey also suggests that the value of new business has stabilised after four quarters of growth. On the other hand, activity is seen as having increased across the sector's most important customer groups – retail, institutional and overseas – with further improvements predicted for the coming quarter.

The life companies also appear to have some contradictory views about the year ahead. In a negative vein, capital investment intentions have declined rapidly, there has been a rapid uptick in concern over the sector's ability to raise capital, and marketing expenditure plans for 2011 appear to have been slashed. However, the improving economic outlook has left respondents less concerned about levels of demand and the effects of competition than at any time in the past year. This mixed set of results is a reminder that UK life insurers are an increasingly diverse group. Although most firms remain committed to domestic growth, there are some targeting overseas expansion and others which have put their businesses in run-off.

Unsurprisingly, the large majority of firms say they are committed to reducing operating costs. This is having a welcome effect on profitability, which almost all see as remaining on an upward trend. More surprisingly, a balance statistic of -85% say that headcount has declined during the quarter and will fall further over the next three months. This is the most negative such response in a year and a half, and does not yet seem to be supported by observable employment reductions in the marketplace.

The life companies also appear to have some contradictory views about the year ahead.

Traders are cautiously optimistic that revenue and profitability will continue to grow...

Securities trading

Growing retail demand has given securities traders their best quarter for activity and revenue in over a year. Traders are cautiously optimistic that revenue and profitability will continue to grow, but they remain concerned about the fragility of demand and the prospect of new regulation.

In December 2009 securities traders reported a strong recovery in sentiment, but this proved to be short lived. Respondents became increasingly bearish over the summer as economic uncertainty mounted and securities markets fell in value. By the time of our June survey the FTSE 100 index had fallen back from a peak of around 5,800 points to nearer the 5,000 mark.[4] However, since early July the equity markets have recovered well, with many analysts predicting that the low interest environment will reward sustained investment in equities. Concerns about Ireland's sovereign debt and the possibility of contagion to other Eurozone countries continue to underline the fragility of the economic situation, but the combination of low but stable UK growth and a belief that interest rates will stay low is allowing many market pundits to form bullish views for FTSE performance.

This confidence appears to be shared by private individuals. With a number of companies beating stock market expectations and disappointing returns available elsewhere, retail investors are putting their concerns over the economy to one side and taking up equities. This has enabled securities traders to report the strongest growth in volumes of business and levels of commission income for over a year. There is also considerable optimism that favourable activity levels will continue into the New Year. With excess capacity remaining in many traders' businesses, this additional volume is expected to deliver strong growth in overall profitability during the next three months.

Looking further forward, some medium-term indicators seem to confirm the sense of cautious optimism. A combination of moderate capital investment plans and a significant increase in marketing expenditure suggests that the sector is hoping to take advantage of a sustained upswing. However, traders remain concerned about levels of demand, the impact of regulatory reform and the availability of professional staff. These factors contribute to a sense of uncertainty and inhibit their ability to plan with confidence.

4 FT.com/marketsdata, 10.12.10.

Investment management

Investment managers' confidence continues to grow, with respondents reporting extremely strong levels of business. Despite increasing spending on regulatory compliance, the sector is enjoying strong profitability and is planning further expansion and product development.

Investment managers report yet another improvement in sentiment, as equity markets continue to rally from the lows of early 2009. Climbing market values help investment managers by boosting fund inflows and pushing up income, so it is no surprise that the growth in confidence is the highest the sector has reported for over a year. For the first time since the heady days of 2005, all respondents see volumes of business as having grown during the quarter. Business with private individuals and financial institutions – the sector's key customer segments – is reported to have picked up strongly, and further improvement is forecast.

In the past this survey has often suggested that investment managers increase their expenditure in line with levels of income, and this quarter is no exception. The sector is allowing its cost base to expand and is one of the few to report an upward trend in numbers employed, despite the impending revision of the FSA's Remuneration Code in line with the amended Capital Requirements Directive.[5] To be fair, regulatory compliance is expected to be a major driver of expenditure during 2011 as investment managers respond to a range of initiatives including the Alternative Investment Fund Managers' Directive (AIFMD), Dodd-Frank, the Foreign Account Tax Compliance Act (FATCA), Undertakings for Transferable Securities (UCITS) and the Retail Distribution Review.

Despite this level of spending, profitability is reported to have increased for the sixth quarter in a row, and the highest balance statistic for more than three years predicts further improvement in the first quarter of 2011. The perception that the sector is enjoying a good run of profitability is supported by the number of recent M&A announcements involving investment management companies, as firms seek to build scale at a time of positive operating leverage. Investment managers' confidence is further underscored by their increasingly upbeat plans for organic expansion, investment in distribution and the development of new products and services.

Investment managers report yet another improvement in sentiment, as equity markets continue to rally from the lows of early 2009.

5 'It could have been worse', PwC, 17.12.10.

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Copies of the full survey are available from the Confereration of British Industry, tel: 020 7395 8071, email: 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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About this survey

This survey was carried out between 22 November and 1 December. A total of 86 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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