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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 86th 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 86th CBI/PwC financial services survey shows the industry enjoying another quarter of recovering sentiment and volumes of business. Further improvements are forecast as the economy continues to recover, although banking respondents strike a notably less confident tone than most. Despite rising costs, profitability is seen as improving. As so often over the past two years, the threat of regulation emerges as a major preoccupation for the industry.

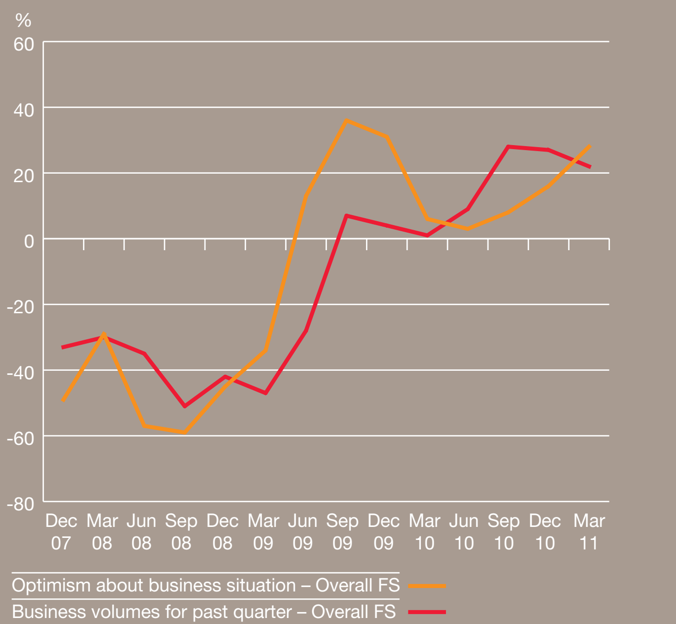
Despite the uncertainty over UK economic recovery, the industry is increasingly optimistic

The survey shows a further improvement in the overall optimism of UK financial services companies, with sentiment reaching its highest level for over a year (see Figure 1). Business volumes are also reported to have increased by a significant positive balance statistic for the third quarter in a row, supporting the industry's run of growing confidence.

The impression of growing optimism is seen across most areas of the financial services industry (see Figure 2). Of the major sub-sectors covered by the survey, all except banking report either an improvement in sentiment or at least a less negative outlook. And with the exception of the banks, all the other major sub-sectors report strong growth in volumes of business and predict further improvements for the coming quarter. The banks are also the only major sub-sector to report falling levels of headcount, although their weighting in the survey has the effect of dragging down aggregate figures (see Figure 3).

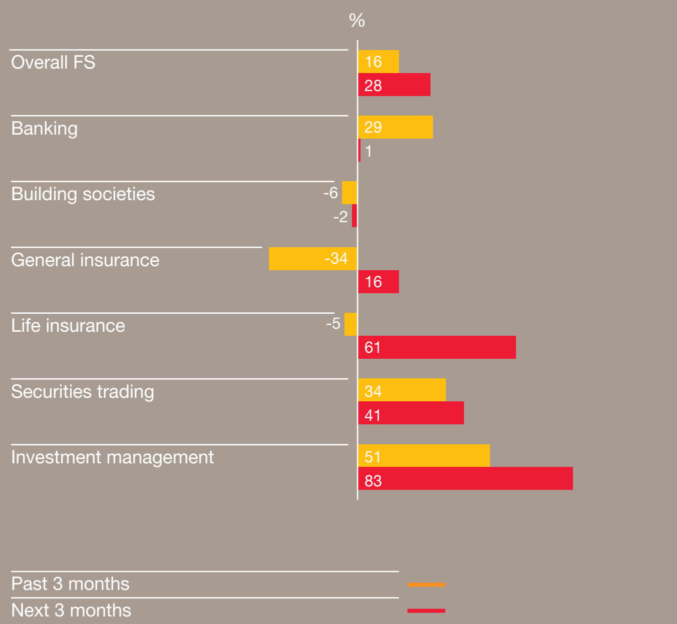
Although it is not unusual for different areas of the industry to generate contrasting survey responses, such contradictory views naturally beg

Figure 1: Optimism and business volumes



Source: CBI/PwC Financial Services Survey, March 2011.

Figure 2: Optimism about overall business situation



Source: CBI/PwC Financial Services Survey, March 2011.

a question: Which interpretation – if either – is correct? Only time will tell, but we note that while the UK economy is still forecasted to grow during 2011, downside risk is seen as having increased during the past few months.[1]

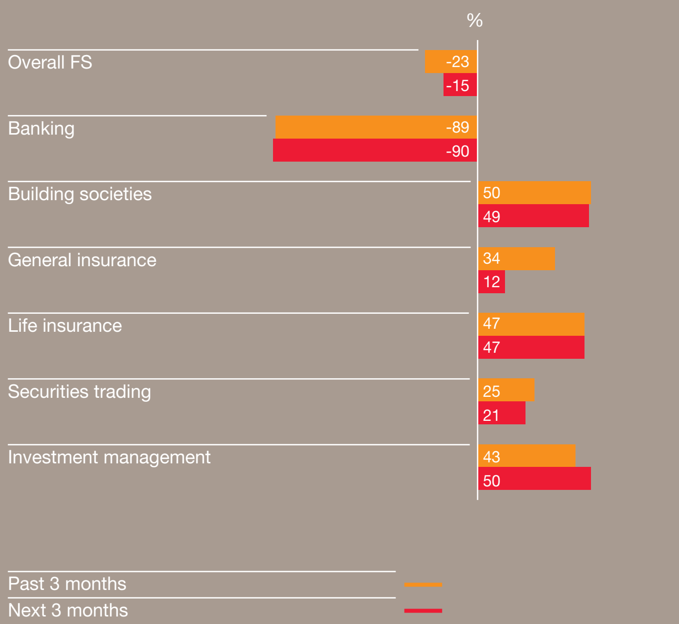
Regulation is seen as a threat to individual companies and the UK's role as a financial centre

The current edition of the survey asks a new supplemental question, namely whether changes in regulation are making the UK more or less competitive as a financial services centre. The results are unambiguous, with 87% of all respondents feeling that new rules have made the UK less competitive. That figure rises to 95% or above among banks, building societies, life insurers and investment managers – all sectors that have felt the force of new regulation since the start of the global financial crisis.

On aggregate, regulation is also identified as the greatest potential limitation on business development, as well as a leading driver of capital expenditure. Compliance spending is expected to increase across the industry during the coming year, as firms grapple with the sheer variety of new regulatory initiatives.

1 '*UK Economic Outlook*', PwC, March 2011.

Figure 3: Numbers recruited



Source: CBI/PwC Financial Services Survey, March 2011.

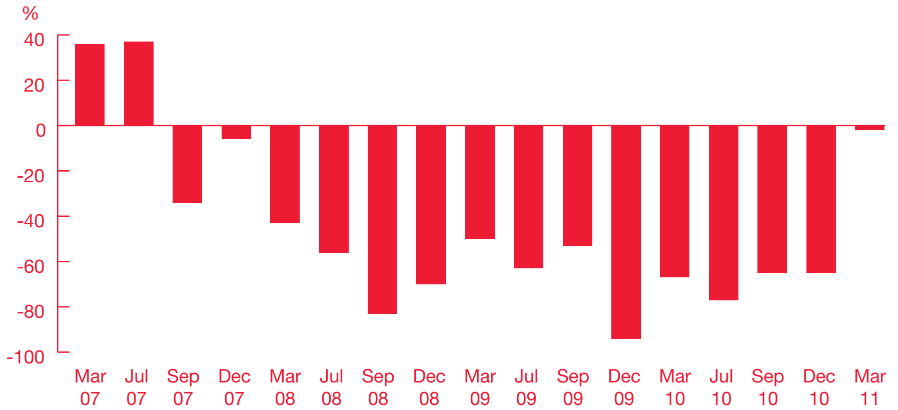
After improving at the end of 2010, banking sentiment has reverted to a neutral stance.

Banking

Banking sentiment remains steady. Respondents report stubbornly flat levels of income, but are hoping to generate stronger growth during the year ahead. Profitability is increasing strongly, even though average spreads remain under pressure.

After improving at the end of 2010, banking sentiment has reverted to a neutral stance. Despite a strong round of annual results the industry still sees some challenges ahead, and the survey shows that levels of demand and new regulation are seen as significant obstacles. It is interesting to note that the banks see their current level of business as being near to normal for the first time since 2007. Despite growth in some areas, banks' activity is still far below that seen before the global financial crisis, so this can only mean that the sector has begun to adjust its expectations of normality.

Figure 4: Banking: Level of business above/below normal, 2007-2011



Source: CBI/PwC Financial Services Survey, March 2007-March 2011.

The survey produces some other contradictory responses. On one hand, volumes of business and the value of income remain stubbornly flat, and hoped-for growth from corporate customers is still yet to materialise. On the other hand most respondents see growing retail demand, and profitability is reported to be strengthening by a balance statistic of +91%, the highest figure in more than 15 years. This looks particularly surprising given the downward pressure on average spreads, although this is offset by steady operating costs and the continued decline in the value of non-performing loans.

When it comes to costs, most banks are looking to do more business with fewer staff, making the sector by far the most bearish in the industry in terms of employment. Even so, other responses suggest the banks remain fairly upbeat about the year ahead. Advertising budgets are growing and most respondents expect to increase cross-selling, acquire new customers and roll out new products. As these strategies develop we would not be surprised to see headcount rise again. It is also clear that technology investment continues to be central to future growth plans.

Building societies

Building societies appear to be adjusting their expectations downwards. Revenues and spreads are both predicted to come under pressure from intense competition in the UK mortgage and savings markets. The value of non-performing loans is expected to begin increasing again.

Building societies' sentiment has now remained relatively neutral for a full year, even though the majority of respondents feel that business has remained 'below normal' throughout that time. This apparent contradiction implies that, while the societies see no current prospect of a return to the boom years, they have yet to adapt fully to lower housing market activity.

At face value, survey responses suggest that the sector has had a pretty good quarter, with volumes of business and the value of income seen as having grown more rapidly than predicted at the last survey. However, these results fly in the face of anaemic growth in the mortgage market[2] and anecdotal evidence that many societies are struggling to write new business.

It is notable that revenue growth is predicted to level off, and the societies report further pressure on margins, which began to fall in December after several quarters of relative stability. This illustrates the strength of competition for customer deposits and mortgage business, an impression reinforced by the increase in marketing expenditure predicted by a balance statistic of +51% of respondents.

Given the outlook for margins, it is not surprising that profitability is expected to weaken in the coming quarter. This is also expected to be influenced by an anticipated increase in operating costs and – more significantly – deterioration in non-performing loans. Balance statistics of +88% expect the value of the non-performing loans to increase during the coming quarter, a rapid turnaround in sentiment and the most downbeat assessment since June 2009. For now arrears remain relatively steady, but societies are clearly concerned about the potential impact of fiscal tightening and growing unemployment. Any increases in the base rate, however modest, are also expected to put pressure on household budgets.

At face value, survey responses suggest that the sector has had a pretty good quarter.

2 '*Market Commentary*', Council of Mortgage Lenders, 18.03.11.

General insurance

General insurers' confidence has swung firmly back into positive territory, supported by increasing volumes of business and stronger reported levels of profitability. The sector continues to develop new avenues of growth, and is investing heavily as it prepares for Solvency II.

General insurers report a clear recovery in confidence from December's strongly negative position. This is only the latest of several swings in sentiment over the past year, as the sector continues to weigh up the impact of competition and low investment yields on its core businesses. Respondents have been cheered by an increase in volumes across personal and commercial lines, even if activity is still seen as being below normal levels. The other notably positive feature of the survey is respondents' increasingly upbeat assessment of profitability, although this result almost certainly conceals a wide variation in performance between different classes of business.

Several responses to the survey suggest that general insurers are willing to invest on the strength of their new-found optimism. Levels of staffing continue to grow and predictions for marketing expenditure have returned to positive territory, as have capital expenditure intentions for IT. The desire to reach new customers is seen as the leading driver of investment, but the need for regulatory compliance has also reached its highest level for two years. Insurers are gearing up for Solvency II implementation and – to a lesser extent – the introduction of IFRS Phase II accounting. It is therefore notable that the availability of skilled managerial staff is identified as the factor most likely to put a brake on capital authorisations over the coming year.

Insurers are clearly giving some thought to developing new avenues of growth. Respondents seem to have identified the acquisition of new customers as a driver of growth, and the continuing push for new international business reveals the sector's desire to diversify beyond the low growth rates and intense competition of the UK market.

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Life insurance

Life insurers are feeling much more confident about their business situation, reflecting strong levels of new business and improving profitability. The survey suggests that some respondents may be planning a push to acquire new customers before the Retail Distribution Review comes into force.

Life insurers report much stronger sentiment, with the confident predictions of the last survey exceeded by actual performance. A majority of respondents report stronger new business, with further growth forecast for the coming quarter. A balance statistic of +86% say that volumes of business are on an upward track and responses on profitability are also extremely bullish, reflecting the improvements in new business and continuing tight control of costs. This confidence is consistent with the generally positive tone of many life companies' full-year results announcements. Aggregate long-term savings levels in the UK increased during 2010, with corresponding effects on many firms' revenues, embedded value and profitability.

Aggregate long-term savings levels in the UK increased during 2010.

Life companies report positive demand from all customer groups, but it is notable that private individuals are seen as taking most of the strain. Although stock market performance during 2010 may have stimulated some demand for investment products, there may also be a connection with the strong upswing in commissions paid. This could reflect a push by life companies to win new business and strengthen distributor relationships before the Retail Distribution Review puts an end to product commissions. This impression is supported by the fact that a balance statistic of +79% of respondents now see the acquisition of new customers as important to their growth strategies, up from a figure of +3% at the last quarter.

Preparation for changing patterns of distribution is a probable driver for the increase in IT investment now predicted by a majority of respondents. The other is regulation, which – owing chiefly to the approach of Solvency II – is identified by almost all respondents not only as a driver of investment but also as a limitation on business development.

Securities trading

Securities traders continue their recent run of optimism, but despite improvements in revenue and profitability the sector is far from getting carried away. Forecasts for the coming quarter suggest a possible slowdown in growth, and traders remain concerned about the impact of new regulation.

Securities traders report a second quarter of growing optimism, showing that the last survey's upbeat sentiment was no fluke. Volumes of business and the value of commission income are also reported to have grown strongly for a second quarter. In part this reflects the volatility of fixed income, currency and commodity markets since the start of the year, but it is notable that forecasts for the coming quarter are slightly less positive. Private individuals continue to be seen as the sector's most important customer segment, but predictions for retail activity appear to be cooling. However, there is a hint of a possible pick-up in demand from the corporate sector.

Volumes of business and the value of commission income are also reported to have grown strongly for a second quarter.

Despite their increasing optimism, securities traders are keeping their feet on the ground. Numbers employed are reported to be increasing, but at a lesser pace than a year ago when many houses were replacing staff shed during the global financial crisis. Respondents also seem to be resisting staff pay inflation, with staff costs declining as a proportion of total costs.

The combination of higher income and carefully managed costs means that a balance statistic of +75% report an increase in overall profitability. Even so, it is noticeable that predictions for the coming quarter – while still positive – are far less bullish.

Securities traders' predictions for the year ahead suggest a mixed outlook. On the positive side, a strong majority of respondents expect customer acquisition to be an important source of growth over the coming year, and developing greater capacity is identified as a leading motive for investment. On the negative side, the advent of fresh regulation overshadows the prospects for business development. There is also a growing view among respondents that they will face increasing competition from new entrants, as firms begin to re-enter markets and businesses they exited during the financial crisis.

4 FT.com/marketsdata, 10.12.10.

All in all, there is no doubt that investment managers are feeling very confident – for now.

Investment management

Investment managers report ever higher levels of optimism, reflecting extremely positive views of business volumes, levels of income and overall profitability. As income grows the sector is increasing its spending on staff, marketing, business development and regulatory compliance.

Investment managers' sentiment is reaching new heights, with almost all respondents feeling more optimistic about their business situation. This makes investment management easily the most upbeat of the major sub-sectors covered by the survey. Headline confidence is even stronger than it was in December, when sentiment was boosted by equity market gains. Even the relatively volatile performance of major indices during the first two months of 2011 does not seem to be worrying investment managers.

Responses to the survey are overwhelmingly positive, with volumes of business, the value of commissions and overall profitability all reported to have increased by balance statistics of over +80%.

Does the reality of investment managers' business situation justify quite such a high level of confidence? There is no doubt that the sector has had a good run, but it is noticeable that 80% of respondents see a low likelihood of financial market deterioration in the next six months. This compares with 32% for the survey population as a whole. Investment managers also seem remarkably bullish given the unprecedented range of new regulation they face, although this is identified both as a major driver of capital expenditure and as a growing limitation on business development.

As investment managers' revenues climb, so too do their levels of expenditure. Numbers employed continue to grow, and a large majority of respondents say that total operating costs are growing. Marketing spend is also widely predicted to increase, although that is not unusual during the final quarter of the tax year. All in all, there is no doubt that investment managers are feeling very confident – for now. It will be interesting to see if this confidence survives into the coming quarter, especially as the impact of the ongoing crisis in Japan becomes clearer.

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Copies of the full survey are available from the Confederation 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.

This bulletin is produced periodically to address important issues affecting the financial services industry. If any of your colleagues would like to be added to the mailing list or if you do not wish to receive further editions, please write to:

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About this survey

This survey was carried out between 24 February and 10 March 2011. A total of 94 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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