

ITEM Club Financial Services

Summer 2011 Forecast



Outlook for Financial Services

The ITEM Club Outlook for Financial Services is a companion to the main ITEM Club Forecast launched for the first time in September 2011 to examine in more detail the implications of ITEM Club's economic projections for the health of the UK financial sector.

The report is organised into three chapters, which in turn examine the banking, insurance and asset management sectors.

Ernst & Young is the sole sponsor of the ITEM Club, which is the only non-governmental economic forecasting group to use the HM Treasury model of the UK economy. Its forecasts are independent of any political, economic or business bias.

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Executive summary

Banking

- ▶ The Independent Commission on Banking (ICB) is due to publish its final recommendations on 12 September, including proposals for the ringfencing of banks' retail operations. Based on fairly moderate assumptions regarding the likely scope of ringfencing, we believe that the cost of wholesale funding to the investment banking divisions would rise by around 100bp, while financial markets would demand a core Tier One Capital Ratio from these divisions of around 14%. This could result in an increase in the cost of bank lending to large UK corporates of up to 150bp. Nonetheless, our analysis suggests that the impact on the wider UK economy is likely to be a reduction of 0.3% of GDP or less.
- ▶ The combination of regulatory change, lower leverage and an uncertain economic outlook means that banks may struggle to lift return-on-equity toward their 12-15% targets. We forecast total assets of the UK banking sector to expand at a significantly reduced rate of just 3%pa during 2011-15. Given these considerable headwinds, there remains a risk that credit shortages could restrict the pace of economic recovery over the forecast horizon.
- ▶ Fiscal tightening and public sector job losses are likely to depress disposable income growth, which will exert renewed upward pressure on default rates for secured and unsecured household lending. And with house prices forecast to fall by a further 5% in the UK overall, there is a risk of higher losses as mortgages will have to be written off net of lower collateral values.

Insurance

- ▶ With household incomes under pressure, the near-term outlook for life insurance premiums appears difficult. Having remained broadly flat last year, we expect life premiums to grow by just 0.5% this year and by 1.7% in 2012.
- ▶ With economic pressures forcing firms to compete for reduced business volumes, non-life premiums are forecast to expand by just 1.5%pa this year and next. Insurers have limited incentive to relocate into the EU under present insurance directives, especially when their sales are increasingly into non-EU economies. The EU policy environment therefore remains an impediment to growth potential of the insurance market within the UK.

Asset Management

- ▶ We believe that the recent sharp declines in stock markets will be partially reversed this year, but assets under management will still be around 9% lower at the end of 2011 as compared to a year earlier. These losses should be recouped in 2012, however, as the recovery in stock markets continues. On the other hand, a sovereign debt default would be a calamitous event for capital markets that would cause assets under management to take another plunge.
- ▶ But the growth of emerging markets leaves open the possibility of the UK fund industry shrinking in relative terms, even if it avoids outward relocation and continues to grow in absolute size.

Introduction

The financial services industry remains an integral part of the UK economy, accounting for around 10% of overall activity and nearly 4% of total employment. Despite concerns about the future competitiveness of London as a global financial centre, it continues to be ranked highly in both survey evidence and in terms of market activity. Nonetheless, it is undeniable that the sector remains fragile in the aftermath of the recent crisis and there are some considerable headwinds in terms of forthcoming regulatory changes and an uncertain economic outlook.

As described in the Summer 2011 Ernst & Young ITEM Club Forecast, the economic recovery in the UK is proving sluggish and there are significant downside risks on the horizon. Our central forecast is for GDP growth of just 1.4% this year, in line with the figure for 2010. Growth is expected to remain sub-par next year at 2.2%, but is forecast to accelerate to 2.5% in 2013.

High inflation is eroding households' purchasing power and will continue to do so until they begin to ease back next year. This pressure is now so intense that spending and saving are both falling. With the government cuts being implemented, this leaves the economic recovery dependent upon exports and business spending.

At the same time, the sustainability of the global economic recovery remains in question, with growth faltering in the US economy and the ongoing sovereign debt crisis in the Eurozone threatening the health of financial markets and the wider economy.

With the UK economy heavily exposed to external developments, the recovery certainly appears delicately balanced at present.

Against this background, we have launched the ITEM Club Outlook for Financial Services as a companion to the main ITEM Club Forecast to examine in more detail the implications of our economic projections for the health of the UK financial sector. Given the financial sector's importance for supporting broader economic activity, the report also examines in detail whether it is in a position to support the recovery.

The report is organised into three chapters, which in turn examine the banking, insurance and asset management sectors.

Banking

Recent financial market turbulence has seen the share prices of banks across Europe suffer disproportionate falls. UK banks did not escape the market rout, which was fuelled by investor fears regarding the weakening economic backdrop, the solidity of banks' capital and the reliability of liquid funding. The bear run also followed closely behind the announcement of first-half results, which showed a sharp drop in UK banking revenues that has further dented confidence in the health of the sector. With financial conditions still fragile and the UK banking sector facing a number of challenges to its future profitability, the outlook for bank earnings appears highly uncertain. As profit expectations are downgraded, this will also raise risks to the ability of UK banks to increase lending and support the economic recovery.

Table 1: Forecast for the UK Economy, Summer 2011

% changes on previous year except interest and exchange rates

Year	2010	2011	2012	2013	2014	2015
GDP	1.4	1.4	2.2	2.5	2.7	2.6
Consumer prices	3.3	4.5	2.5	2.0	1.5	1.6
Average earnings	3.2	2.0	2.3	3.0	3.1	3.8
Unemployment rate (% of workforce)	7.9	7.9	8.2	8.1	7.7	7.2
Government net borrowing (% of GDP)	10.1	8.2	6.5	4.4	3.0	1.9
Effective exchange rate	80.5	79.6	78.7	77.7	76.4	74.9

Source: ITEM

Optimism has faded this year...

Current levels of pessimism surrounding the UK banking sector represent a sharp volte-face from the initial optimism at the start of the year. At that point the UK banking sector was celebrating the good progress made in 2010, with loss-making banks returning to profitability earlier than originally expected.

In fact, the underlying picture was more mixed. In particular, the improvement in performance was driven mainly by a sharp reduction in impairment provisions, rather than revenue growth, which remained broadly flat across the retail and commercial businesses. The main success story of 2010 was investment banking, as these divisions generated exceptionally strong results, which also helped to drive a renewed upturn in hiring.

This upturn proved short-lived, however, as profits slumped amidst subdued trading volumes and higher funding costs in the first half of this year. And with the deterioration in market conditions clouding the outlook for future revenues, renewed job cuts have been announced by several UK-domiciled investment banks in recent weeks. The performance of retail and commercial banking divisions has also generally been lacklustre this year, given the weak economic environment within Europe, although banks with significant exposure to the emerging markets have benefitted from buoyant demand in these economies.

... as the economic outlook has clouded

The deterioration in confidence regarding the UK banking sector has been compounded by the slow pace of the domestic economic recovery. Activity in the

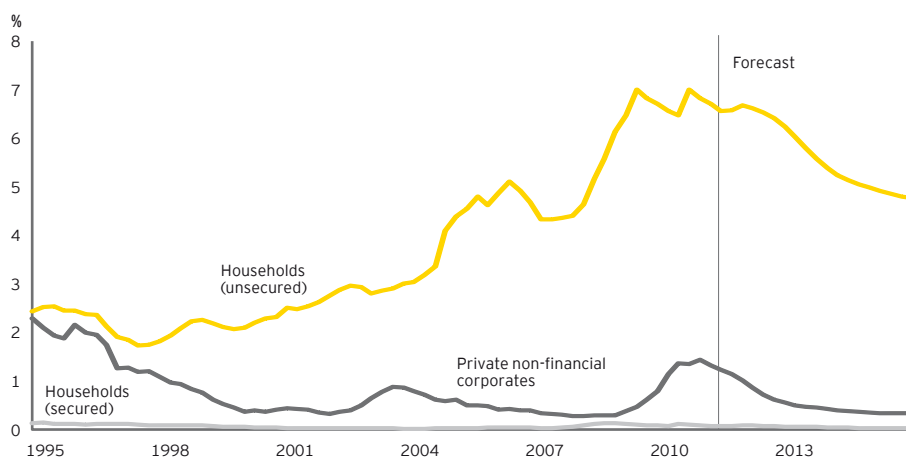
UK economy proved weaker than expected during the first half of 2011, as the global economy experienced another 'soft patch' in growth. Although we expect this slowdown to prove only temporary, our central forecast shows UK GDP growth of just 1.4% this year, with only a moderate acceleration to 2.2% in 2012.

The housing market has also experienced a renewed softening over the past year, with prices having so far declined by around 1% from their 2010 peak according to the Nationwide measure. With demand fundamentals remaining weak, and the banks unlikely to ease lending criteria substantially in the immediate future, our central case is for house prices to continue falling into next year, with prices declining by a further 5%.

Losses on residential mortgages have so far remained very low due to the exceptionally low level of short-term interest rates. But there is likely to be renewed upward pressure on arrears and defaults on secured lending as the UK government's fiscal tightening starts to bite, with the risk of higher losses in the near-term as mortgages will have to be written off net of lower collateral values. The less diversified commercial banks, especially those that specialise in buy-to-let mortgages (which typically have higher loan-to-value ratios than mainstream lending), are likely to be hardest hit. Arrears on unsecured lending are also likely to pick up following recent declines. Notwithstanding these short-term rises, the average annual level of arrears should still drift lower this year and next (see Table 2). Still, diminished prospects for improvements in arrears will discourage banks from increasing lending, which could further compound the weakness in consumer spending and the housing market.

Chart 1.1: Write-offs of bank loans by sector

Source: ITEM/Bank of England



Commercial property could present future problems

While the non-financial corporate sector as a whole remains in good financial health, the Bank of England has identified higher levels of financial stress amongst small companies. The future trend in commercial real estate also remains highly uncertain. Having suffered deep declines in value, the Property Industry Alliance believes that about 80 percent of all loans made for commercial real estate since 2004 may be in breach of their loan-to-value covenants. While loan repayment forbearance by banks has helped to keep default rates low, impairments could clearly rise very rapidly in the event that conditions in the sector suffered a renewed deterioration. Negative equity would also expose banks to higher losses following default. If commercial property portfolios produce tangible losses this year, this would put further strains on banks, with potential knock-on effects for lending to the wider economy.

Regulatory outlook adds to uncertainty

Pressures to deleverage are being reinforced by the regulatory outlook and the tough stance of UK authorities toward reform in the banking sector. Although recapitalisation measures by the UK industry and the authorities have made average capital ratios in the UK banking sector amongst the strongest in Europe, UK regulators are putting pressure on the weaker banks to build up capital ahead of the official 2019 deadline to meet Basel III requirements. The Financial Stability Board has also endorsed plans for globally systemically important banks to face a capital surcharge of between 1% and 2.5% above the 7% Tier One Capital threshold under Basel III. Although the Basel Committee has not yet published its scoring of the world's largest banks, it has made public the measures it will use and their relative weightings. Based on this formula

and the current business models of the banks, it is likely that three UK banks would face the top surcharge.

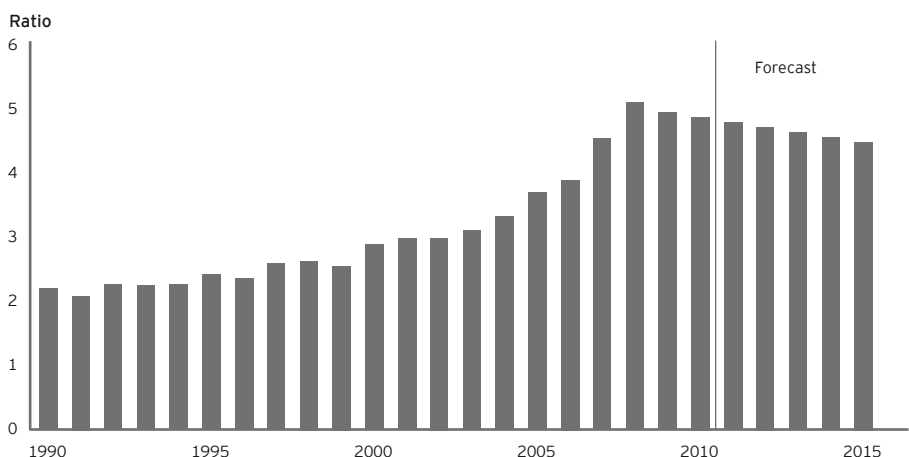
Moreover, the Bank of England Governor, Mervyn King, is urging UK banks to build capital buffers above these regulatory minima. This is contributing to uncertainty about the capital levels that the UK authorities will ultimately require. The Independent Commission on Banking (ICB) also proposed in its interim report that universal banks should be forced to ringfence their retail operations, which would need to hold a minimum of 10% core Tier One capital (significantly higher than the Basel III minimum threshold of 7%).

The rationale for the ringfence is that the authorities could credibly commit to allowing the riskier investment banking division to fail if it ran into trouble. These reforms could therefore lead to credit-rating downgrades for the investment banking divisions, given that the main credit-ratings agencies incorporate the impact of implicit government support within their main ratings of UK banks. Financial markets would also be likely to impose higher funding costs and demand higher capital levels, which could have a significant impact on the profitability of these divisions. In contrast, funding costs within the retail ringfence could decline marginally, as investors perceive that the government has essentially confirmed that the retail businesses would not be allowed to fail under any circumstances. For this exercise we have therefore assumed that any repricing of lending will only occur within loan books positioned outside the ringfence.

Although the interim report did not make any firm recommendations for the design of the ringfence, it would most likely include household lending and small business loans within the retail operation, while large corporate loans would sit outside the ringfence due to their close ties with the investment banking division. With this

Chart 1.2: UK banking sector assets/GDP

Source: ITEM/Haver Analytics/Bank of England



in mind, borrowing costs for these large companies could rise substantially.

A simple exercise can illustrate the potential impact on the UK economy. First, we have assumed that the investment banking divisions face an increase in wholesale funding costs of around 100bp. Clearly, this estimate is subject to a high degree of uncertainty, as it is difficult to forecast the reaction of financial markets to the reforms, but we feel it is a reasonable assumption given the scope of ringfencing we have described. Second, we assume that the loss of implicit government backing for the investment banking divisions and the restrictions on the ability of the ring fenced entity to fund other activities of the group prompts financial markets to demand that they maintain a core Tier One Capital ratio in the region of 14%. As all the universal banks in the UK already hold core Tier One Capital ratios in the region of 10%, it would represent a rise of around 4% points. Based on BIS estimates, the effect of a 1% rise in bank capital requirements would be a 13 basis point increase in borrowing costs facing the economy, so this 4% rise implies an increase in lending costs of around 50 basis points.

If we assume that the banks pass on all these lending costs through higher pricing of loans, the combined effect would be a 150bp rise in lending costs to large corporates. Using the HM Treasury Model, we have estimated that a 150 basis point increase in lending costs facing the whole economy would lower the level of GDP in the UK by around 1.2% in the absence of offsetting monetary policy actions. As large corporate loans represent less than 25% of overall lending, however, this implies a GDP loss in the region of just 0.3%. This estimate may also be overstating the effect as large businesses have access to alternative sources of funds from debt and

equity issuance in the capital markets, as well as being able to borrow from foreign banks. We can therefore conclude from this analysis that the impact of ringfencing on the wider UK economy isn't likely to be vast. However, the loss of corporate loan business to capital market alternatives or even foreign banks will compound the loss of market share for universal banks in the UK. The knock-on effect of losing other banking and advisory mandates from major corporates would have further implications for the long-term competitiveness and profitability of the UK banking sector and it remains difficult to quantify the impact of this on the wider UK economy at this stage.

Admittedly, how the ringfence is designed will also determine the likely impact on banks. For example, it is very likely that ringfencing would also prevent banks from using protected funds, such as customer deposits, to subsidise operations outside the fence, although normal arms length relationships in usual business conditions are likely to be allowed. In this case, banks will also need to hire new personnel to cover functions that were previously run jointly. But the most strict versions of the ring fence might disallow even normal arms-length relationships. In this case, the associated increase in costs would be more significant than the effect of increased capital requirements and higher wholesale funding costs outlined above. Indeed, it could present a significant challenge to the longer-term feasibility of the universal banking model. But the interim report appears to have rejected these more extreme options for segregating retail and investment banking divisions.

The Commission is due to publish its final recommendations on 12 September, which will provide the basis for the Government's reform of the banking sector that will be drafted into law during 2012.

Table 2: Banking

Year	2010	2011	2012	2013	2014	2015
Total assets (£bn)	7,067	7,253	7,421	7,642	7,902	8,187
Core Tier 1 capital (% RWA)*	9.9	10.2	10.6	10.9	11.1	11.2
Total loans (£bn)	5,489	5,411	5,433	5,492	5,704	5,956
Consumer credit (£bn)	127	127	130	134	139	146
Write-offs (% loans)	6.7	6.6	6.4	5.7	5.1	4.8
Business/corporate loans (£bn)	479	477	500	536	575	618
Write-offs (% loans)	1.3	1.2	0.7	0.5	0.4	0.3
Residential mortgage loans (£bn)	1,044	1,036	1,031	1,068	1,114	1,164
Write-offs (% loans)	0.08	0.06	0.04	0.04	0.03	0.01

* Numbers reported in this table do not take into account the effect of new Basel III rules, which will exclude lower-quality instruments from the definition of core tier one capital.

Source: ITEM, Bank of England

EU stress tests fail to restore confidence

As widely anticipated, the publication of the EU stress test results on 15 July did not identify any UK bank that fell short of the minimum capital threshold specified in the tests. The 'adverse scenario' used in the tests assumed that UK GDP would contract by 0.7% in 2011, with growth of just 0.9% in 2012. Within the Eurozone, GDP growth would be -0.5% in 2011 and -0.2% in 2012. Charges on trading and banking books were imposed to reflect the deterioration of the economic environment, including weakening conditions in residential and commercial property, sovereign bond and securitised asset markets.

As the overall results were largely in line with expectations, the general market impact was limited and the results were quickly overshadowed by news on the handling of the Eurozone sovereign debt crisis. Crucially, the stress tests did little to restore confidence in the health of the European banking sector as they were widely viewed by market participants as being too lenient. In particular, the 'adverse' scenario considered by the new European Banking Authority (EBA) in this year's tests did not include the impact of a formal debt default by a European government, which is the single greatest risk facing the European banking sector at present.

The IMF also recently conducted a Financial System Stability Assessment (FSAP) Update for the UK, which included a more strenuous 'severe double dip' scenario where GDP contracted by 4.3% over a two year horizon. When combined with haircuts on sovereign and bank debt holdings, the IMF concluded that such an event could

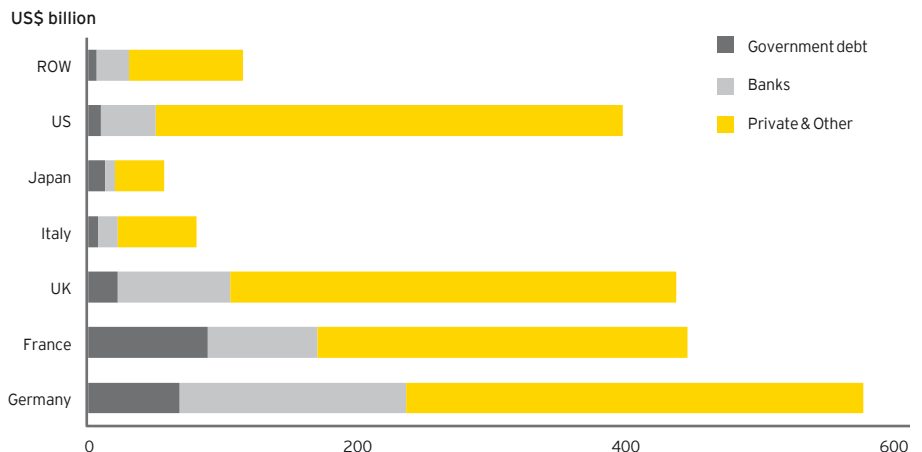
still pose significant challenges, resulting in a capital shortfall within the banking system of up to 1.8% of GDP. But these tests also did not fully consider the potential fallout of an intensification of the Eurozone sovereign debt crisis. As such, there has still been no stress test published by an official institution that is strenuous enough to consider the likely fallout on the UK banking sector of a double-dip recession in Europe combined with the severe stress in global financial markets that would accompany a formal default by a Eurozone government.

Although BIS data shows that the direct exposure of the UK banking sector to sovereign debt of the Eurozone peripheral economies (Greece, Ireland, Spain and Portugal) is actually quite low, overall exposure to these economies is much higher, amounting to around \$430bn or 19% of GDP. The bulk of these exposures are to households and the non-financial corporate sectors of Spain and Ireland. In the event of a sovereign default, losses to UK banks could therefore be very significant if there is spillover to these economies.

Recent debates in Europe over whether banks require more capital, sparked by comments from the new head of the IMF, Christine Lagarde, reflect the ongoing uncertainty created by the lack of credible stress test results. UK banks also remain heavily dependent on wholesale funding markets, which have not recovered from the crisis and would be disrupted in the event of a sovereign default. Uncertainty in the wider European markets is adding to pressure on banks' balance sheets, which will have a direct knock-on effect on lending to the UK economy.

Chart 1.3: Bank exposures to the peripheral Eurozone economies

Source: ITEM/Haver Analytics



Prospects for UK banks remain subdued...

The financial crisis has left a lasting mark on the UK banking sector, whose performance in coming years will be unable to match the performance of the pre-crisis period. With private sector debt levels remaining high, this will constrain future loan demand. Regulatory developments will also limit leverage, restrain the size of balance sheets and increase the cost of financing. Indeed, the funding gap between loans and deposits in the UK poses material deleveraging risks. Future growth in retail deposits is likely to exceed growth in loans as banks seek to reduce their reliance on funding from potentially volatile wholesale markets in accordance with new Basel III guidelines. These new rules will also force banks to hold more liquid assets on their balance sheets, which will act as an additional constraint on their capacity to lend.

Against this background, our forecast implies that the total assets of the UK banking sector will expand at a relatively subdued pace during 2011-15, with growth averaging around 3% per annum. This represents a clear break with recent historical experience - during the ten years leading up to the financial crisis, total assets of the UK banking sector roughly doubled as a share of GDP. In the wake of the financial crisis, it is clearly appropriate that some banking activities are downsized or disappear altogether to curtail excessive risk-taking. But there is a risk that the pressures on banks to deleverage will also result in unwelcome credit constraints that will dampen growth in the wider economy.

As interest rates begin to rise, this will help improve margins within the retail and commercial banking businesses. Within investment banking divisions, our forecast for equity markets to continue rising will support profitability, but conditions will

not be as favourable as last year, so future performance is unlikely to be as positive. On the other hand, M&A activity should pick up as the economy recovers.

Regulatory changes and lower leverage will also act as headwinds to profitability across the banking industry. Banks may therefore struggle to lift return-on-equity toward the 12-15% targets recently announced by several firms, despite these returns being significantly below the levels achieved before the crisis. It is therefore likely that UK bank shares will remain under pressure and will struggle to match the performance of the FTSE All-Share even as the market recovers. Banks will need to take a hard look at costs and new growth opportunities for example emerging markets or insurance to hope to get anywhere near pre crisis levels.

...and constraints on lending could undermine the economic recovery

Given the significant headwinds facing UK banks, especially in terms of both international and domestic regulatory reform, there remains a risk that credit shortages could restrict the pace of economic recovery over the forecast horizon. While UK banks have declared themselves "open for business", the Bank of England reported in their Q2 Credit Conditions Survey that the availability of credit had remained broadly unchanged for businesses and households in the three months to June. More worryingly, the turmoil in financial markets has since raised the cost of funding for banks, which is likely to feed through to higher spreads on lending. And with capital market issuance having ground to a halt in recent months, alternative sources of finance for the corporate sector have been severely curtailed. Against this background, the availability of credit remains a key risk to the sustainability of the UK economic recovery.

Chart 1.4: Relative performance of UK bank equities

Source: ITEM/Haver Analytics



Insurance

The UK insurance industry returned to positive growth in 2010 following two very difficult years. Capital levels recovered with the rise in asset values (although these gains have been partially eroded in recent weeks) and premium income is picking up, although it remains below the 2007 peak. Nonetheless, business conditions remain challenging amidst an uncertain economic outlook and volatile financial markets.

EU stress tests confirm the resilience of UK insurers

Stress tests conducted in Q2 2011 under European Insurance and Occupational Pension Authority (EIOPA) supervision confirmed the health of the UK sector, which was judged to stay above Solvency II minimum capital requirements even under their most adverse stress scenario. The Europe-wide pass rate of over 90% sparked criticism that the tests were too lenient, especially as they did not consider the implications of a sovereign debt default. But the UK sector earlier showed its resilience by staying intact through the financial market and economic downturns of 2007-8, at an earlier stage of Solvency II preparation.

The stress test results show that insurers remain free of the systemic risk exposure (and counterparty risks) that arose in 2008 for US-based insurers that had taken on credit risk exposure through credit default swaps. They also confirm that earlier industry fears about the restrictive impact of Solvency II have been addressed by refinements to the new regime, now due to start in January 2013. UK industry associations' concern has shifted from the potential impact of higher capital requirements on product cost (especially

of longer-term life cover) to the general shift of regulatory design from national regulators to the EU, which may diminish the regulatory design advantages that previously attracted multinational insurers into the UK.

EIOPA has, however, raised concerns over the division of regulatory responsibility from 2013, when the Bank of England's Prudential Regulation Authority (PRA) will take over the supervision of the largest insurance groups while the new Financial Conduct Authority monitors smaller firms' compliance with conduct-of-business rules. The main doubt is whether the PRA will be able to scrutinise insurers based elsewhere in Europe and operating in the UK on 'passporting' approval, which comprise around one-third of all business. This may make it difficult to ensure that levels of policyholder protection and arrangements for resolution are consistent with UK standards.

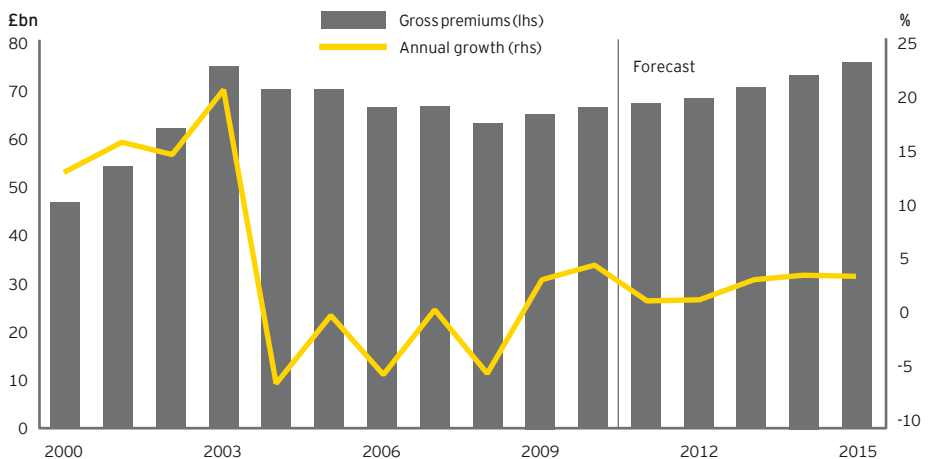
The recommendations of the Independent Commission on Banking, which centre on ringfencing of investment and commercial banking activity, are unlikely to alter the current distribution pattern for insurance, in which retail banks are a principal channel, often cross-selling insurance with their core services.

Non-life business remains under pressure...

The UK is the world's third-largest insurance provider and its income has continued to grow, supported by the large London-based reinsurance market. But high insurance penetration rates in the UK signal that it is a maturing market with limited growth potential in the domestic market. Indeed, non-life business in the UK has grown less rapidly than business outside the EU.

Chart 2.1: Gross non-life premiums

Source: ITEM/OECD



Insurers have limited incentive to relocate into the EU under present insurance directives, especially when their sales are increasingly into non-EU economies. The EU policy environment therefore remains an impediment to growth potential of the insurance market within the UK.

Latest estimates indicate that the non-life premium volumes of UK insurers expanded by 2.0% in 2010, helped by higher premiums. But this rebound is likely to prove short-lived, as economic pressures force firms to compete for reduced business volumes, which will make it difficult to increase premium rates further. Our forecast is for gross premium income to expand by just 1.5%pa in 2011/12, before growth picks up to around 3.5%pa during 2013-15 as economic conditions improve.

A trend rise in motor insurance claims, which has led to sharp increases in premium rates since 2000, is set to level off. The cause of the rise, despite falling accident rates, has been traced to the growth of specialist claims companies and their use of re-traded information on accidents including some from insurers themselves. Forthcoming legislation against re-trading of information should reduce the scale of injury litigation and hence reduce fraudulent claims.

...and life insurance faces regulatory changes

After falling sharply in 2008/09, gross life premiums remained broadly flat last year, amidst ongoing weakness in disposable incomes. The near-term outlook for growth in premium volumes also remains difficult, as household incomes remain under pressure - we forecast personal disposable incomes to contract by 1.2% in real terms this year, with positive growth of just 1.4% in 2012. Moreover, there has been a tendency for the recent recovery in household savings to take the form of debt reduction (rather than increased savings provision which includes life-linked products).

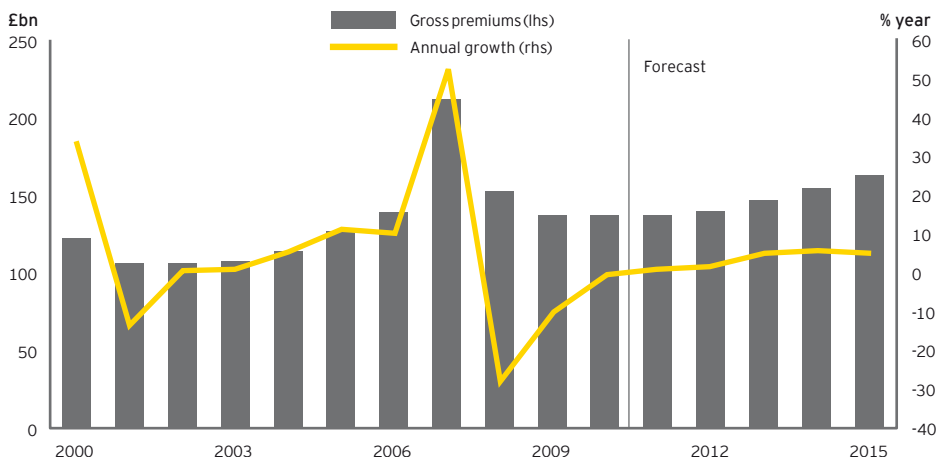
The renewed softening of house prices, which we expect to extend into next year, will further weaken demand. Indeed, insurance brokers have reported stagnant or falling business and softening of fees and commissions in H1 2011, confirming a drop-out by some households and greater cost-cutting concern among those still in the market. Against this background, we expect life premiums to expand by around 0.5% this year and by 1.7% in 2012, although annual growth should rise above 5.0% thereafter, in line with stronger real income growth.

Discrimination on gender grounds in premium setting will be outlawed from the start of 2013, following a European Court of Justice ruling in March 2011. This will require insurers to equalise premiums for accident- and medical-related cover, for which women tend at present to be charged less because of lower risks; and to equalise the cost of annuities, for which women tend currently to pay more due to longer life expectancy. However, changes will only take effect when the Equality Act is amended in 2012, and will not apply to existing policies; and it may still be possible to set different premium rates according to non-discriminatory criteria that proxy for gender difference. This will limit the extent of price adjustment needed, as well as demand.

The Dilnot Report on long-term care arrangements, published in July, identifies significant obstacles to creating a market in private insurance, but recommends a number of state-led policies that could encourage some individuals to purchase cover. The most significant would be a requirement on households that can afford it to meet up to £50,000 of old-age care costs, through either insurance or withdrawal of housing equity. The recommendation of a maximum (of £25,000-£50,000) on household contributions is designed to make an insurance approach affordable.

Chart 2.2: Gross life premiums

Source: ITEM/OECD



The difficulty of meeting the initial cost of the cap (estimated at £2bn annually, rising towards £3bn as the population ages) could make the present proposals difficult to enforce, but they potentially open the way for new forms of long-term care and health insurance for which demand would quickly grow, first to plug the existing gap in provision and then in line with the growing numbers who need or anticipate such provision. If political strategy swings behind this increase in demand, insurers would also come under pressure to manage supply, by working more closely with care-home and old age healthcare providers.

Forthcoming RDR presents challenges to new business volumes

Implementation of the FSA's Retail Distribution Review, which sets out new professional standards in the retail investment sector, will add to the costs of regulatory compliance for the insurance industry and present new business challenges. The new rules come into force at the end of 2012 and will affect all regulated firms involved in producing or distributing retail investment products and services including independent financial advisers (IFAs), wealth managers, stockbrokers and retail fund managers. While there is general support for the principles underlying the reforms, there remains some concern amongst industry professionals over the practical application of the new regime, such as the restructuring of IFA fees to remove all commission from pension and investment products. The requirement for IFAs to sit mandatory exams could also have the unintended consequence of encouraging more senior staff to retire. Research by Ernst & Young suggests that at least one-third of the 30,000 advisers currently in the UK will leave the industry by the end of next year. If realised, the sharp reduction in IFAs could

have a significant negative impact on new business volumes for insurers.

Asset management

Stock market declines have reduced the value of managed funds...

The value of funds under management in the UK recovered strongly during 2009-10 after declining with the worldwide stock and bond market correction in 2008. Total assets under management rose by 21.6% to £588bn in 2010 according to data from Lipper FMI (which allocates funds according to the country origin of those assets), with growth strongest for equity funds due to the recovery in stock markets. Net inflows, as measured by retail sales of open-ended investment companies (OEICs) and unit trusts, also rebounded strongly for all fund types except money-market funds. But these gains will have been partially reversed this year as the recent sharp declines in global stock markets have eroded the value of assets under management.

... and threatened to reverse the recovery in inflows

Prior to the recent turmoil in financial markets, asset managers were benefitting from higher inflows as the UK savings rate rose in response to the worrying economic backdrop, and appetite for investment through financial assets picked up amidst weak prospects for the housing market and the low interest rate environment. Inflows to UK-based funds was also picking up from elsewhere in Europe as a rising flow of privately invested household savings made use of the single market to target management in large financial centres closely connected to major exchanges. The UK has also gained from an inflow of funds seeking management from outside Europe into the Eurozone, encouraged by

Table 3: Insurance

Year	2010	2011	2012	2013	2014	2015
Total gross premium (£mn)	203,087	204,686	208,046	217,273	227,834	238,586
% year	0.6	0.8	1.6	4.4	4.9	4.7
Total gross claims payments (£mn)	155,924	142,694	142,855	145,418	149,446	154,569
Total claims ratio (%)	77	70	69	67	66	65
Life gross premium (£mn)	136,716	137,400	139,736	146,804	154,728	162,885
% year	-0.1	0.5	1.7	5.1	5.4	5.3
Life gross claims payments (£mn)	126,811	114,891	115,580	118,007	121,076	124,950
Life claims ratio (%)	93	84	83	80	78	77
Non-life gross premium (£mn)	66,370	67,286	68,310	70,469	73,106	75,701
% year	2.0	1.4	1.5	3.2	3.7	3.6
Non-life gross claims payments (£mn)	29,113	27,803	27,275	27,411	28,370	29,619
Non-life claims ratio (%)	44	41	40	39	39	39

Source: ITEM, Bank of England

its promotion of standardised fund formats. UK implementation of the four undertakings for collective investment in transferable securities (UCITS) directives has ensured that OEICs become internationally recognisable and marketable. One-third of client inflows since 2002 have been from overseas, according to the IMA. This contributed to a 20% rise in funds in UK-authorized OEICs and unit trusts during 2010, raising their share to 15% of all funds under management in the UK. But the renewed decline in stock markets could undermine this renewed confidence amongst retail investors, leading to increased withdrawals.

Private contribution pension schemes offer opportunities for expansion

Nonetheless, owing to under-funding in the public sector and deficits in the private sector, the breakdown of defined benefit pension funds offers particular opportunities for industry expansion, as private defined contribution (DC) schemes become a larger component of most individuals' retirement funding. Although well advanced in the UK, the switch to DC is now underway across Europe, with more households seeking supplementary private provision even where state provision remains generous. Expansion of DC pension saving in the UK is set for a further boost with the launch in October 2012 of personal accounts under the National Employment Savings Trust, which will represent a default scheme into which employees will be enrolled.

Outlook for assets under management remains positive

We believe that the recent sharp declines in stock markets will be partially reversed this year, but assets under management will still be around 9% lower at the end of 2011 as compared to a year earlier. These losses should be recouped in 2012,

however, as the recovery in stock markets continues. Thereafter, growth is expected to average around 5% pa. In contrast to the cautious move beyond conventional asset classes, UK managers have been pro-active in diversifying equity and bond portfolios abroad, making use of falling transaction costs and regulatory harmonisation; access to other markets ensures a growth contribution from rising asset values as well as further inflows, even if UK asset prices stay subdued.

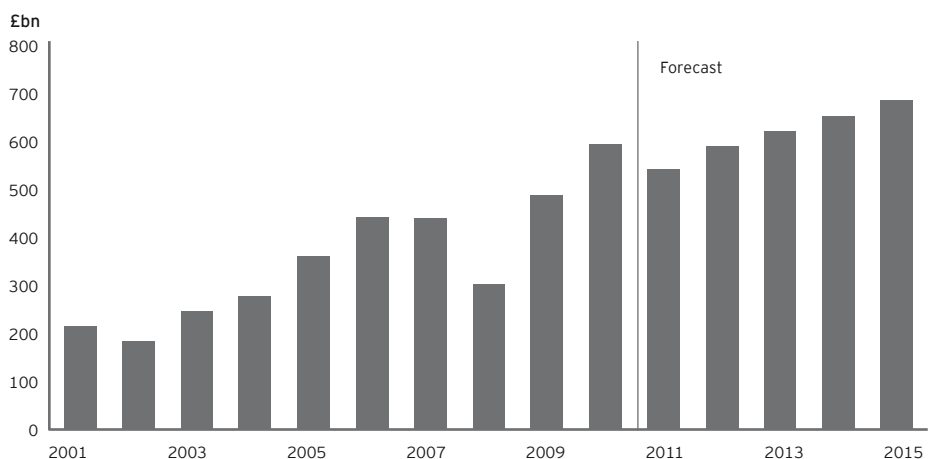
Traditional fixed income and equities still dominate portfolios...

While some larger UK pension funds in the 2000s moved further towards the 'Yale Model', with a larger portfolio proportion assigned to alternative assets, the damage to this model in the US since 2008 has tended to quell its appeal elsewhere. According to the IMA, the aggregate allocation of UK fund managers in 2010 was still 46% equities, 36% bonds and 9% money-market, with only 6% in 'alternative' asset classes. Although the caution over alternatives could reflect continued concern about their likely medium-term performance, the survey suggests regulation is also a factor, with Solvency II driving some larger insurance funds away from alternative investments.

The European Institutional Asset Management Survey, survey shows the proportion of equity held in portfolios fell to 27% in 2010 from 29% in 2009, with that of fixed income rising to 58% from 51%. Corporate bonds formed a rising proportion of the total, mainly due to doubts about the safety of some formerly mainstream European public and US municipal debt. But polls of intentions suggest this was a feature of market timing, with many funds preparing to move back into equities and expand in real estate once prices are more competitive.

Chart 3.1: Assets under management in the UK

Source: ITEM, Lipper FMI



UK and Irish fund managers remain unusually high in the proportion of portfolios assigned to private equity - averaging 7.3% in 2010 according to the 2011 EIAM with only the Nordic countries (at 5.2%) coming close. The proportions assigned to hedge funds were also significantly higher in the UK and Ireland (3.7%), Switzerland (3.1%) and the Scandinavian countries (5.2%) than any other surveyed country in Europe. However, the UK and Ireland's 8.1% average allocation to real estate was not unusual and was exceeded by the Benelux countries (11.9%) and Switzerland (9.5%).

As it has grown, UK fund management has increasingly defined itself as a separate industry, distinct in terms of structures and skill-sets from banking and insurance and retail distribution arrangements. This has improved its ability to lobby for appropriate regulation and tax treatment, but has also increased the scope for competition as large sources of funds seek independence and monitor its performance more closely. While this has enabled management teams with strong track records to attract additional mandates and command larger funds, it has also promoted the growth of low-cost index-tracking and exchange-traded funds that avoid high management costs.

While index funds lost ground during the 2008-09 downturn, following the market down while active managers could try to beat the index through stock selection and market timing, the 'trackers' have equally reliably followed the market upwards in 2009-10, and are expected to maintain their low-cost appeal, especially to those who regard markets as too efficient to be consistently beaten by active managers. Passive management accounted for 41% of pension fund assets and 38% of all funds under management in 2010, according to the IMA survey.

... but increasing prominence of emerging market activity ...

The growth of emerging markets leaves open the possibility of the UK fund industry shrinking in relative terms, even if it avoids outward relocation and continues to grow in absolute size. UK-based funds have for a long time been diversifying into other OECD equity and bond markets, motivated by the additional opportunity

to diversify risk and enabled by falling transaction costs. Strong growth prospects in emerging markets (especially Asia) and the expansion of middle-class wealth there, makes it increasingly likely that asset management in emerging financial centres will start to outgrow that in the UK. Large emerging markets' launch of pension funds and other long-term investment funds will further promote fund-management growth outside the EU, with Anglophone centres such as Hong Kong and Singapore already benefiting from regional expansion that largely escaped the downturn in the industrialised world.

... means asset management should outpace the real economy

UK and EU financial centres' continued expansion will depend on revival of their economies as well as retention of their current regulatory, tax and reputational advantages. The expectation of tighter regulation and possibility of higher financial-sector taxation, as a result of the 2008-9 financial crisis is another factor that could slow the further expansion of UK asset management relative to that in financial centres outside Europe and North America. Competition among managers for market share, and the growing popularity of passive management strategies to reduce cost, could also restrain the growth of fee income. Despite these moderating factors, demand for the industry's services is set to rise faster than GDP. Since emerging nations' fast-expanding middle- and higher-income earning groups are also looking to internationalise their portfolios, there is considerable scope for a two-way flow of funds under management, and UK managers' pursuit of worldwide business is likely to be promoted by their growing independence from distribution. So the sector is forecast to continue growing faster than the overall economy over the medium term, with the global growth in demand for professional management of defined-contribution investment offsetting the competitive pressure to drive down management costs. While the labour market for experienced high-profile managers is increasingly international, expansion of funds under management will continue to correlate with expansion of sector employment within the UK.

Table 4: Asset management

Year	2010	2011	2012	2013	2014	2015
Total assets under management (£mn)	588,290	537,510	585,086	614,924	646,274	679,214
% year	21.6	-8.6	8.9	5.1	5.1	5.1

Source: ITEM, Oxford Economics

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