

ITEM Club Financial Services

Winter 2011/12 forecast



Outlook for Financial Services

The ITEM Club *Outlook for Financial Services* is a companion to the main ITEM Club forecast launched 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 sharp downgrade of the ITEM economic forecast for the UK economy presents a more challenging operating environment for the banking sector, which is already struggling with the burden of costly regulatory changes. Bank profits will remain under pressure, forcing additional rounds of cost cutting and lay-offs. Many banks will have to reappraise their core business models as they continue to restructure, stripping away less profitable units.
- ▶ With economic activity weakening, the outlook for loan demand appears subdued and confidence will not return until a credible solution to the Eurozone crisis is in sight. At the same time, we expect banks to introduce stricter lending policies in response to the worsened outlook for loan quality as well as high costs of funding on wholesale markets. After expanding by an estimated 4.3% in 2011, we expect total loans to contract by 2.2% in 2012, with only very modest growth of 0.9% envisaged in 2013. Shortages of credit could therefore pose more problems this year for businesses and households.
- ▶ Banks' funding costs (as measured by yields on their bonds) have been higher than those of their large corporate clients since the 2007 crisis and our expectation is that regulatory and financial market developments will ensure that this disparity is maintained for some time. This creates incentives for these corporate customers to raise funds outside the banking system, potentially encouraging a shift away from bank lending towards more bond financing, as already happens in the United States.
- ▶ Disintermediation of lending activity is also underway in consumer credit, as an increasing number of households are finding that banks will only lend to the most financially sound borrowers, forcing them to turn to alternative high-cost consumer credit providers, such as payday loan companies. Net lending by these consumer credit providers has increased by 42% since the beginning of 2007, while unsecured lending to individuals by banks and building societies contracted by 23% over the same period. With banks expected to further tighten lending conditions, contributing to our forecast of a 5.4% contraction in consumer credit from banks during 2012, it is likely that these new lenders will continue to expand their provision of credit to poorer borrowers.
- ▶ We estimate that the UK would account for three-quarters of potential revenues from an EU-wide financial transactions tax (FTT). Even if the UK opts out of the FTT, it could still account for more than half of the expected revenues from the introduction of an FTT in the Eurozone. Taking account of the spillover effects outside the financial sector, associated job losses in the UK from an FTT in the Eurozone would likely amount to around 4,500.

Insurance

- ▶ Although the insurance industry has so far remained fairly healthy compared to other financial services sectors, this strength will be tested in coming months. Our forecasts point to subdued demand for insurance products in the near term, reflecting the constraints on households' disposable income and prioritisation of debt repayment. We expect gross life premiums to grow by just 0.1% in 2012, while non-life premiums grow by 1.1%. This implies intensified competition for declining business volumes in the domestic market, leading to consolidation through exit or acquisition of smaller players. In this environment, insurers with a focus on emerging markets will benefit from a potential source of much faster-growing demand.
- ▶ The market for life products is set for gradual recovery, but will not match the rapid growth achieved before 2008, whose subsequent reversal highlighted the sensitivity of demand to income. Higher capital requirements will raise the cost and limit the appeal of some previously popular savings-related products. Moreover, higher contribution requirements (along with rising annuity costs) are a threat to participation in pension schemes which the National Employment Savings Trust (NEST) auto-enrolment will not start to tackle significantly before 2014.
- ▶ Non-life insurers experienced a sharp rise in claims in 2011, within the UK and globally, which will require a further rise in premiums. But with spare reinsurance capacity still reported, this is unlikely to signal an end to the down-phase of the underwriting cycle. Premium rises to date have mainly been concentrated in motor policies, where they have not yet matched rising costs. And Solvency II rules are likely to impede the capital adjustment that normally precedes a general hardening of premiums.

Asset management

- ▶ Although UK net sales of retail funds went negative in H2 2011, institutional fund management remained relatively buoyant, helped by defensive inflows from the Eurozone and contrarian buying of equities, from which retail buyers continued to retreat. The outlook for retail and institutional markets is subdued in 2012 by Eurozone sovereign debt and bank problems, with recovery in funds under management dependent on an equity market upturn.
- ▶ Against this background, we forecast total assets under management to expand only marginally, by 0.4%, over the course of this year. But prospects look more positive from 2013, when financial market conditions should improve, prompting renewed inflows of funds. We expect growth in assets under management to average around 8% per annum during 2013-15.
- ▶ Absolute-return funds suffered from high correlation in 2011 but are set to recover in 2012 despite continued volatility, and will remain a growth area fuelled by clients requiring higher returns. With demand for lower cost pushing more retail demand towards tracker funds, managed funds still pursuing benchmark or peer-group strategies will have to roll out lower-cost versions to retain a mass market under UCITS IV.

Introduction

The Eurozone crisis has already put UK business spending on hold, while the consumer is still struggling with the effects of fiscal austerity and rising unemployment. Against this background, the Ernst & Young ITEM Club Winter forecast concluded that the UK economy appears almost certain to enter a technical recession in Q1 2012; the key question is over how severe it will be. Even assuming an orderly resolution to the problems in the Eurozone, the UK will struggle to post positive growth this year, with the economy expanding by just 1.8% in 2013. But the current resilience of the US and many other overseas markets, together with an expected fall in inflation, should help the UK to avoid a serious double dip.

The forecast sees business investment flat in the first quarter of this year, before starting to pick up again in the second half of the year as some of the uncertainties dissipate. Business investment is forecast to rise by 3.9% for the year as a whole; however, this still means that at the end of 2012 the level of business investment will be 13.6% below its pre-crisis peak. With investment in dwellings flat or falling and government investment being cut back by 12% a year or more, total investment expenditure is expected to be broadly flat in 2012, after a 2.6% fall in 2011.

Weak economic activity will contribute to a further rise in unemployment from already elevated levels. The forecast shows unemployment just under three million next spring, equivalent to 9.3% of the workforce. That will dampen consumer spending just as the pressure of inflation on disposable incomes begins to abate.

The risks to this forecast are skewed to the downside – the Eurozone crisis remains a key source of uncertainty and a series of disorderly defaults would have significant negative repercussions for the UK economy.

Against this background, we present the latest 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. The report is organised into three chapters, which in turn examine the banking, insurance and asset management sectors.

Banking

Difficult conditions will force a reappraisal of business models

The ITEM Club forecast for Winter 2012 concluded that the UK economy has probably already slipped back into technical recession (defined as two consecutive quarters of negative GDP growth), albeit a short and shallow one. GDP growth is now seen at just 0.2% for 2012 and 1.8% in 2013, representing a sharp downgrade to previous forecasts of 1.5% and 2.5% respectively. The forecast still assumes that problems facing policymakers in the Eurozone are successfully negotiated, but with the chances of a less orderly outcome for the Eurozone having increased in recent months, this implies significant downside risks to the outlook.

The renewed deterioration in economic conditions will present a more challenging operating environment for the banking sector, which is already struggling with the burden of costly regulatory changes.

Table 1: Forecast for the UK economy, Autumn 2011

% changes on previous year except interest and exchange rates

	2010	2011	2012	2013	2014	2015
GDP	2.1	0.9	0.2	1.8	2.8	2.6
Consumer prices	3.3	4.5	2.3	1.9	2.0	2.0
Average earnings	3.8	1.8	1.9	2.9	3.3	3.9
Unemployment rate (% of workforce)	7.9	8.1	9.0	9.2	8.8	8.2
Government net borrowing (% of GDP)	10.1	8.5	7.8	6.4	4.7	3.1
3-month interest rate	0.7	0.9	1.0	1.8	2.8	3.7
Effective exchange rate	80.5	80.0	81.5	80.4	79.1	77.5

Source: ITEM, Bank of England

The difficult domestic backdrop implies a worsening of credit quality, as well as lower demand for credit, which will hit associated earnings. Market volatility will also dampen investment banking fee income from M&A activity and other advisory work, while trading conditions are likely to also prove difficult. Against this background, bank profits will remain under pressure, forcing additional rounds of cost cutting and layoffs. Many banks will have to reappraise their core business models as they continue to restructure, stripping away less profitable units.

Write-offs of bank loans are forecast to rise this year...

The weaker outlook for the economy implies increased upward pressure on write-offs, which will have a direct adverse effect on bank profitability. Data from The Insolvency Service shows numbers of corporate insolvencies were already on a rising trend during the first three quarters of 2011 and we expect a further significant rise in coming quarters. Consumer-facing industries are likely to face a particularly difficult period, given our forecast for consumer spending to grow by just 0.2% this year and by 1.4% in 2013. Sectors ranging from retailers to hotels and restaurants are likely to suffer a rise in bankruptcies due to slumping sales.

The outlook for commercial real estate also appears difficult and capital values could come under renewed pressure, especially in secondary markets where occupation prospects are weakest. While loan repayment forbearance by banks has so far helped to keep default rates low, impairments could clearly rise very rapidly in the event that conditions in the sector suffer a renewed deterioration. Negative equity would also expose banks to higher losses following default.

Arrears on unsecured lending are also likely to pick up in light of the expected weakness in household incomes and further rises in unemployment. Data from the Labour Force Survey (LFS) suggests that the labour market has already deteriorated sharply, with the International Labour Organisation (ILO) data for the three months to October showing the unemployment rate increased to 8.3%. This is above the level it had reached during the recession and the highest level in 18 years. We expect the ILO unemployment rate to peak at 9.3% in the first half of 2013 and to then drop back only very gradually.

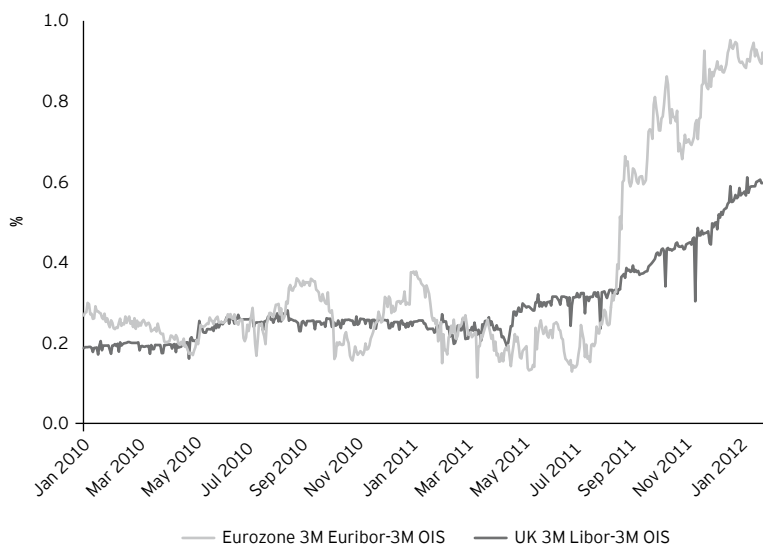
The housing market has been moving sideways in recent months and we expect this trend to continue during the first half of 2012, with prices mounting a gradual recovery thereafter. Losses on residential mortgages have so far remained very low due to the exceptionally low level of short-term interest rates, although there is also evidence that underlying distress has been masked by forbearance. Research by the FSA and Bank of England indicates that, in the absence of forbearance, the mortgage arrears rate might have been 0.5% points higher in Q3 2011 at 1.7%. Data collected by the FSA suggests that provision coverage on mortgages in forbearance is around three times higher than coverage on other mortgages, so if more losses are realised they should still be manageable. With rates forecast to remain at their current level of 0.5% until the first half of 2013, this should help to keep a lid on upward pressure on default rates on secured lending.

...and loan growth is forecast to turn negative

High levels of uncertainty linked to the ongoing problems in the Eurozone mean that many businesses are putting their investment plans on hold, while the more

Chart 1.1: UK and Eurozone interbank spreads

Source: ITEM/Haver Analytics



difficult financial situation for households means they are likely to focus on improving their balance sheets over the coming year. As a result, the outlook for loan demand appears subdued. At the same time, we expect banks to introduce stricter lending policies in response to the worsened outlook for loan quality as well as high costs of funding on wholesale markets. After expanding by an estimated 4.3% in 2011, we expect total loans to contract by 2.2% in 2012, with only very modest growth of 0.9% envisaged in 2013. Shortages of credit could therefore pose more problems this year for businesses and households.

The Bank of England reported in its Q4 Credit Conditions Survey that the availability of credit for businesses and secured credit to households had remained broadly unchanged in the three months to mid-December 2011, while the availability of unsecured credit to households had increased. But other data from the Bank of England illustrates how smaller companies are being affected by credit restrictions – the average interest rate on new advances of £1mn or less was 3.81%, more than two percentage points higher than the average 1.72% charged on loans larger than £20mn. This spread averaged just 0.5 percentage points during 2004-08, but it has since been on an upward trend. Although the Credit Conditions Survey reported that lenders are expecting a small increase in overall credit availability in the coming three months, lenders commented that developments in the Eurozone and their impact on banks' funding conditions would be a key determinant of domestic credit conditions.

Financial conditions for UK banks are not currently as difficult as for those in the Eurozone, despite longer-term financing having dried up. Although interbank

spreads have continued to widen, for example, they are still well below Eurozone levels, suggesting markets are less worried about counterparty risks posed by UK banks. But the interconnectedness of the European banking system means that the UK money market could still freeze up again if the Eurozone crisis escalates. Although the Bank of England has made contingency plans for this outcome, banks would still be likely to rein in lending if this occurred.

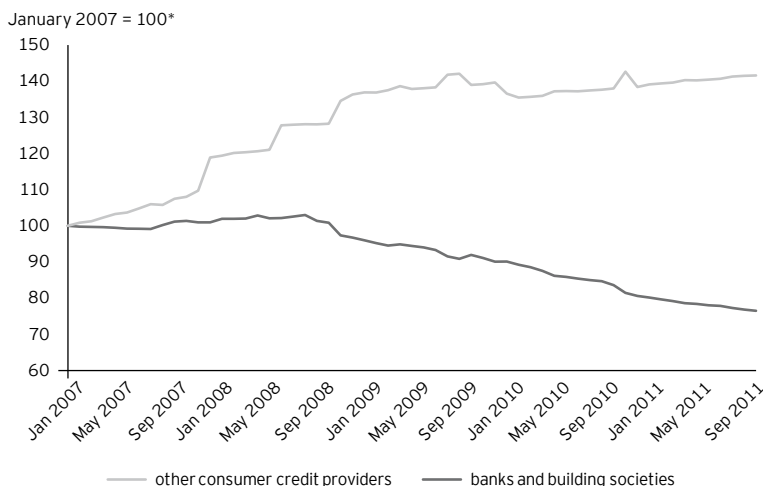
Regulatory changes are likely to push up funding costs...

The Treasury plans to push ahead with the Independent Commission on Banking (ICB) report proposals, entailing the ring-fencing of retail savings in banks that have wholesale and investment banking operations. Banks will face higher capital requirements and higher funding costs, which will represent a significant drag on return on equity and force banks to carefully review the optimum mix and location of their business. Although the implementation timetable stretches out to 2019, the ICB has urged the UK Government to complete the ring-fence sooner. Despite the current lack of detail regarding the design of the ring-fence, lenders have therefore started to engage in early strategic planning ahead of an official announcement on the rules.

The ICB report recommendations may accelerate a shift toward funding on a secured basis that is already underway. This is because the explicit preference for retail depositors contained within the proposal will push unsecured bondholders further down the repayment hierarchy. While banks will attempt to pass on the higher cost of capital to customers in the form of higher prices, this may not be feasible in practice due to competitive pressures. This

Chart 1.2: UK consumer credit

Source: ITEM/Bank of England



is especially true for large non-financial corporates that could most easily shift their business to non-UK banks and/or obtain financing in the bond markets.

One important detail that the Treasury has announced is that the overseas arms of multinational banks will be exempt from the new rules. This will put internationally focused banks at less of a disadvantage relative to their non-diversified rivals – those with significant operations in emerging markets are likely to outperform as they will also benefit from stronger growth in these economies.

...encouraging more borrowers to access the 'shadow' banking system

Banks' funding costs (as measured by yields on their bonds) have been higher than those of their large corporate clients since the 2007 crisis and our expectation is that regulatory and financial market developments will ensure that this disparity is maintained for some time. This creates incentives for these corporate customers to raise funds outside the banking system, potentially encouraging a shift away from bank lending and toward more bond financing, as is already happening in the United States. Investment funds and investment companies could also play a more significant role in corporate credit provision. Nonetheless, banks still have a comparative advantage in terms of their expertise in managing the risks associated with lending activities, so it may become more common for banks and institutional investors to collaborate in corporate financing activities. While the disintermediation of bank lending will reduce bank income from lending, investment banks might therefore offset the impact on earnings by generating more fee-based revenue.

It is not just the corporate sector where disintermediation of lending activity is underway. An increasing number of households are finding that banks will only lend to the most financially sound borrowers, forcing them to turn to alternative high-cost consumer credit providers, such as payday loan companies. According to Bank of England data¹, net lending by these consumer credit providers has increased by 42% since the beginning of 2007, while unsecured lending to individuals by banks and building societies contracted by 23% over the same period (see chart 1.2). With banks expected to further tighten lending conditions – contributing to our forecast of a 5.4% contraction in consumer credit from banks during 2012 – it is likely that these new lenders will continue to expand their provision of credit to poorer borrowers, thereby capturing a growing share of the lending market.

The UK accounts for three-quarters of potential revenue from an EU-wide FTT...

Proposals for a European tax on financial transactions (FTT) present another potential threat to the health of the UK banking sector. The European Commission published an economic impact study in September 2011 that presented estimates of the potential tax revenue that could be generated by a European-wide FTT. The study concluded that the FTT has the potential to raise around €37bn each year (2010 prices), with the potential for an additional €16bn of revenue if a spot foreign currency transaction tax (CTT) is also imposed².

For an analysis of the net impact of the FTT on the EU public finances, please refer to the Ernst & Young Eurozone Financial Services Outlook Winter 2011/12. Here

Table 2: Banking

Source: ITEM/Bank of England

	2010	2011	2012	2013	2014	2015
Total assets (£mn)	7,071	7,294	7,383	7,555	7,802	8,085
Total loans (£mn)	5,489	5,727	5,600	5,648	5,871	6,083
Consumer credit (£mn)	127	119	112	115	120	126
Write-offs (% loans)	6.8	5.7	6.4	5.6	5.1	4.9
Business/corporate loans (£mn)	479	455	429	445	489	553
Write-offs (% loans)	1.3	1.7	1.9	1.2	0.7	0.4
Residential mortgage loans (£mn)	1,044	1,056	1,068	1,091	1,133	1,182
Write-offs (% loans)	0.06	0.05	0.06	0.05	0.03	0.01

¹ We have adjusted the original Bank of England series to account for the break in January 2010, when securitised loans were reclassified from 'other credit providers' to the balance sheets of the originating MFIs.

² As the taxation of spot currency transactions could pose considerable legal issues as well as having the potential to disrupt the free movement of capital, this option was excluded from the study's headline estimates.

we consider the FTT in isolation, modelling what proportion of revenues would be generated by the City of London in two scenarios. The first scenario considers the introduction of the FTT across the EU including the UK; the second scenario assumes that the UK opts out but is still affected by the introduction of the FTT in the Eurozone due to the use of a reverse charge mechanism.

How the revenues of the FTT would be distributed at the national level was not calculated by the European Commission's impact study, but the authors acknowledged that revenues would be distributed unevenly, in line with trading volumes at EU exchanges. In order to calculate the proportion of revenue that the European Commission expects would be generated in London by an EU-wide FTT, we have estimated the share of UK trading volumes in overall turnover at the EU level for each of the market segments affected by the FTT³. As shown in table 3, our data confirms that the City of London dominates EU trading in almost every market apart from equities. Taking the European Commission's estimates at face value, this data implies that the UK would account for 77% (€41bn) of the total potential revenue that could be generated by an FTT. Excluding the CTT, UK revenues would amount to a share of 75% (€28bn) of the total projected EU revenues (€37bn).

...and may still account for over half of revenues even if the UK opts out

Although the UK Prime Minister, David Cameron, has pledged to veto the introduction of an FTT at the EU level, a number of individual member states have voiced their commitment to push ahead with the tax at the national level, with the aim of applying the FTT throughout the Eurozone. In this event, the impact on the UK would depend very much on the design of the tax. For example, there has been some discussion of the application of a reverse charge mechanism for the FTT, such that all trades denominated in euros would be subject to the tax, irrespective of where the trade takes place. As many euro-denominated trades take place in London, this could effectively impose an FTT on the UK through the 'back door'.

We can make a rough calculation of the proportion of total revenues that a Eurozone FTT could potentially generate from the UK by estimating the share of euro-denominated trades in each market segment, as set out in table 4⁴. The implied UK revenues from a Eurozone FTT are then calculated by applying these shares to the UK revenue estimates in row 3 of table 3. They show that the UK financial sector could be expected to contribute 64% of total revenues from an FTT imposed at the Eurozone level⁵. Excluding the CTT, the UK financial sector would account for 58% of total revenues. Moreover, these revenues would flow directly to governments in the Eurozone rather than to the UK Exchequer.

Table 3: EU-wide FTT revenue estimates

	Equities	Bonds	Exchange-traded derivatives	OTC interest rate derivatives	Foreign currency	Currency swaps	Currency outright forwards	Total	Total (without CTT)
(1) Estimated EU revenues (€bn)	4.7	8.8	11.3	7.8	16.0	3.7	0.8	53	37
(2) Share of UK in EU trading (%)	30	84	89	74	81	65	80	77	75
(3)=(1)*(2) Implied UK revenues (€bn)	1.4	7.4	10.1	5.8	12.9	2.4	0.7	41	28

Note: Revenue estimates exclude non-financial sector transactions (estimated to be 15% of overall trades by the European Commission)
Source: European Commission, ITEM

Table 4: Eurozone FTT revenue estimates

	Equities	Bonds	Exchange-traded derivatives	OTC interest rate derivatives	Foreign currency	Currency swaps	Currency outright forwards	Total	Total (without CTT)
(4) Euro-share of UK trading (%)	5	30	50	54	70	70	70	n/a	n/a
(5)=(3)*(4) Implied UK revenues (€bn)	0.1	2.2	5.5	3.1	9.1	1.7	0.5	22	13
(6)=(1)-(3) Implied Eurozone revenues (€bn)	3.3	1.4	1.2	2.0	3.0	1.3	0.2	12	9
(7)=(5)+(6) Total revenues (€bn)	3.4	3.6	6.7	5.1	12.1	3.0	0.6	35	22

Note: Revenue estimates exclude non-financial sector transactions (estimated to be 15% of overall trades by the European Commission)
Source: ITEM

³ Our estimates draw upon a variety of sources, including the Federation of European Securities Exchanges, the World Federation of Exchanges, the BIS and TheCityUK.

⁴ Again, we have drawn upon a range of available data, but we have also had to estimate these shares in some cases.

⁵ The revenue that would be generated by the FTT on Eurozone trades is calculated as the difference between rows (1) and (3) in Table 3. The calculations in row (6) of Table 4 show that total revenue from the Eurozone itself would likely amount to around €12bn, or €9bn if the CTT was excluded. Row 7 adds the implied revenues from the UK and Eurozone to produce an estimate of total revenues from a Eurozone FTT.

The Eurozone FTT could result in around 4,500 job losses in the UK

The European Commission study concludes that the FTT would have only a small direct impact on overall employment, as job losses would mainly be concentrated within investment banks where employment intensity is very low. However, the UK is likely to bear the brunt of these losses, given that the majority of the affected financial activities take place there. Potential spillover effects to other forms of employment may also be substantial, as workers in the securities industry consume a range of goods and services, thereby supporting other business sectors.

In order to estimate the potential impact on employment in London, we rely on academic studies of the relationship between stock market volumes and securities industry employment based on data from New York. A stock transfer tax (STT) was imposed at the state level in New York in 1909, but the tax was repealed in 1981. Using this experience, a number of studies have attempted to model the impact on the city's economy of reviving the STT. For example, a 2004 report produced by the Partnership for New York City⁶ estimates a stock market volume-securities industry employment elasticity of 0.61 to 0.64, meaning that a 10% decrease in traded volume lowers employment in the securities industry by between 6.1% and 6.4%. These results appear broadly in line with a number of earlier studies.

According to TheCityUK, employment in the securities industry amounted to around 200,000 jobs in 2010⁷ of which we estimate around a third, or 60,000, are involved in euro-denominated business. We make the conservative assumption that the Eurozone FTT results in a reduction of 5% in trading activity in London, due to reduced volumes of business in euro-denominated trades. Combining this with the midpoint of the above elasticity estimate and the 2010 level of employment, this suggests that the FTT would result in the direct loss of around 2,100 jobs in the securities industry in the year following the introduction of the tax. Moreover, there would be spillover effects to other businesses in London as well as outside the capital. Using multiplier estimates for the financial services industry from Oxford Economics' UK Inter-Regional Input-Output Model, we estimate

that total job losses in the capital would amount to 3,150, while job losses in the UK as a whole would be 4,500. However, over time it is likely that the employment impact would dissipate, as financial activity in London was redirected away from euro-denominated business and toward more profitable trading activities.

Insurance

The insurance industry faces a difficult outlook in the near term, characterised by a weak recovery of demand and increases in cost due to tighter regulation and heavy natural disaster claim costs in 2010-11. These factors are likely to delay the cyclical upturn in underwriting profits that would normally be expected at this stage, on the basis of industry consolidation and reduced capacity.

Consolidation likely among life insurers as competition intensifies

Premium subscriptions to life and pensions have continued to decline from their 2007 peak. Although there has been some increase in personal pension contributions since 2010 - linked to households' general move to raise retirement saving - the decline in group pension contributions has so far outweighed this. Our forecasts point to subdued demand in the near term, reflecting the constraints on households' disposable income and prioritisation of debt repayment, resulting in gross life premiums expanding by just 0.1% in 2012, before picking up to 2.8% in 2013. Demand for single-premium policies, the main product, will start to pick up in 2013 in line with household income growth; however, it will not repeat the rapid growth achieved in 2006 and 2007, which was followed by an equally sharp decline in 2008-10. The higher cost of long-term products with income guarantees, because of the higher capital provisions they require under new regulation, will further limit the re-expansion of investment plans linked to life insurance.

The near-term outlook is for intensified competition for declining business volumes, leading to consolidation through exit or acquisition of smaller players. It is largely this (with the consequent scope to release reserves) that has driven the recovery in profit for some leading life providers in the past two years.

⁶Schwabish (2004), "The Stock Transfer Tax and New York City: Potential Employment Effects"; Partnership for New York City Issue Brief

⁷Total financial jobs in The City of London and Canary Wharf

Auto-enrolment unlikely to provide a significant boost in the near term...

New pension subscriptions will be boosted from October 2012 by the launch of automatic enrolment into occupational pension schemes for employees aged over 22, to be administered by the National Employment Savings Trust (NEST) where there is no employer plan available. Auto-enrolment is intended to produce a much higher participation rate than previous opt-in schemes, and ensure provision for employees of the estimated 750,000 firms that currently offer no occupational pension. However, the scheme will initially apply only to larger businesses (employing 50,000 or above), for many of which changes will be minimal because occupational schemes already exist. It will be extended gradually to smaller firms, set to be heavier users of NEST, with those employing up to 50 workers not required to join until May 2015. This staged introduction may prove beneficial for the retention of enrolments, since it gives more time for new members' real incomes to recover, so that they consider the required contributions affordable and remain opted-in.

The advantage to scheme members (and to pension fund managers) over personal pensions is that employers and government will supplement employee contributions, substantially increasing the overall flow of pension saving. NEST will, however, add to the existing pressure to make fund management charges more transparent and bring them down. Competition with other forms of pension provision will intensify if, as widely expected, new rules permit employees to transfer past contributions to other schemes into NEST, to consolidate their pension pots from different employments before retirement.

EU proposals for bringing defined contribution schemes into the Solvency II framework, currently being coordinated by the European Insurance and Occupational Pensions Authority (EIOPA), could also significantly increase the cost of UK schemes, including NEST. As the UK life market is substantially larger than EU counterparts' – mainly because of annuity sales – the Government has already had to negotiate over the details of Solvency II to avoid a rise in capital requirements and reduction of flexibility. Progress towards this stalled in early-2012 talks, and there remains a risk that life providers will have to tie up significant extra capital especially where they have made bonus guarantees to long-term policyholders based on earlier, over-optimistic predictions of investment growth.

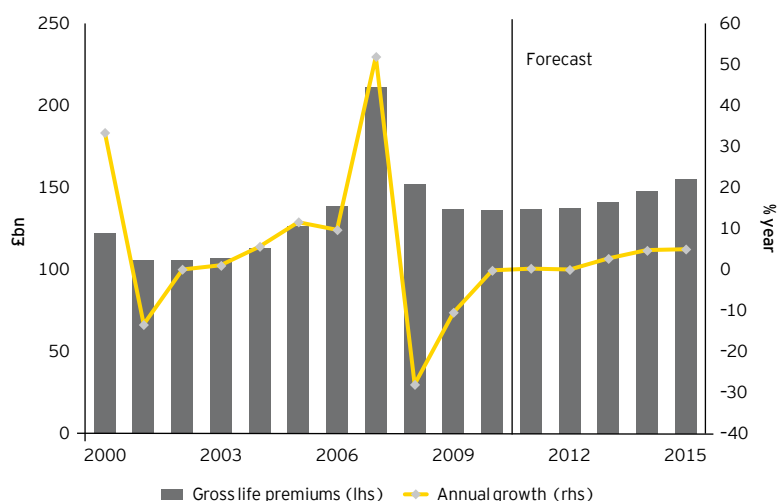
... and low interest rates could discourage pension saving

Sustained low interest rates and rising longevity have combined to raise the cost of annuities (in terms of the pension saving needed to buy a pound of guaranteed income) to the point where the annuity is losing popularity as a way to convert pensions on retirement. This reflects the recent decline in gilt yields to near-record lows, reflecting the 'safe haven' status of the UK amidst the Eurozone crisis, as well as the Bank of England's money-printing programme. Although the ITEM Club envisages only a gradual rise in yields, if our expectation for them to hit 5% by late 2013 plays out, this would still help to relieve a significant amount of the current pressure on annuity costs.

A widely expected rule change that would allow retirees to take small pension pots as cash could further encourage the move away from annuities. While the industry can adapt to this shift, the long phase of low pension-fund returns and declining

Chart 2.1: Gross life premiums

Source: ITEM/OECD



annuity rates raises the danger that pension saving will be deterred altogether, with more households choosing to rely on an only marginally improved state pension. The rapid and ongoing shift of existing occupational schemes to defined contribution (money purchase) from defined benefit (now mostly closed to new members) has reduced the appeal of employer-linked pension schemes in general, while generally poor performance of personal pensions (linked to high charges) has limited their take-up even by workers with no possibility of an occupational scheme. Higher contributions to public-sector pensions, enforced by the Government following the Hutton Report, are expected to cause some dropping-out of these schemes even though this means a sacrifice of employer contributions. The same choice may be made by some lower-income employees enrolled into NEST, and the long-term rise in pension saving due to the new scheme remains very hard to predict.

The UK life sector's main distribution channel, independent financial advisers, is also undergoing consolidation as a result of the FSA's Retail Distribution Review (RDR), with its higher prudential capital requirements and minimum qualifications for advisers taking effect in 2013. Advisers and brokers have boosted their market share since 2008, mainly at the expense of direct sales, and these intermediaries accounted for around half of investment-linked insurance sales (by value) in the second half of 2011. But customers' ongoing concern to avoid visible charges will also sustain the growth of sales via platforms (around 40% of the total in the second half of 2011).

Emerging markets provide opportunities for growth ...

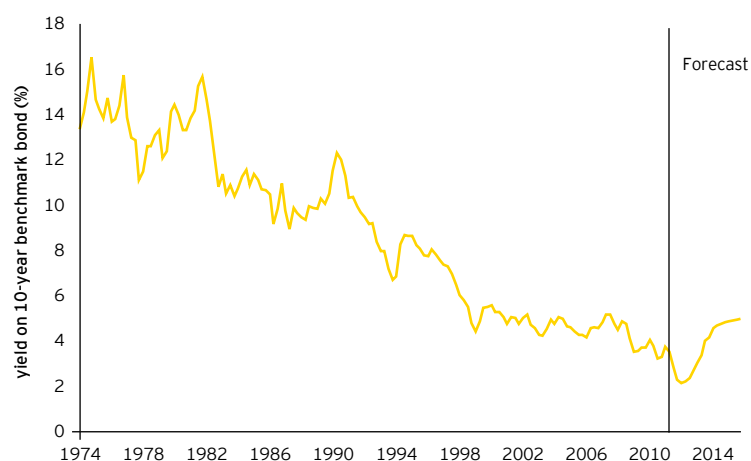
Emerging markets, especially in Asia, remain a potential source of much faster-growing demand due to rapid income growth and limited state provision of pensions and welfare. Regulation, as well as the need for local market knowledge, often requires UK-based insurers to enter new non-European markets via local providers; however, the need for more private provision is pressuring governments to make foreign entry easier, and slow growth in existing high-income markets (especially in Europe) will increase sales and marketing investments further afield. Local providers, especially those that link to EU or US partners, will achieve a knowledge transfer that eventually enables them to capture business from multinationals, however, from their small base life-product sales in emerging markets will outpace those to established markets throughout 2012-15.

Heavy natural disaster claims still being felt by non-life insurers...

Globally, 2011 is set to have been the biggest ever year for insurance payouts, with US\$380bn of losses and US\$105bn of claims (on Munich Re estimates) for natural disasters. The biggest arose from the Japanese tsunami and New Zealand earthquakes, but floods in Thailand and a sharp rise in US weather-related damage also contributed to a bill which is set to go above premium income, having stayed close to it in 2010 (when claims were boosted by the Chilean earthquake and Mexican Gulf oil spill). The previous record was for claims of US\$101bn, set in 2005. Extreme weather events have been rising in scale and expense, but their total cost and insurance cost varies substantially

Chart 2.2: UK government bond yields

Source: ITEM/Haver Analytics



with location. The suspected but unclear link with global warming compounds the problem of predicting future expense. Large man-made disaster risks are also increasing as commercial pressures lead to the adoption of more complex technologies, as exemplified by the Mexican Gulf deep-water drilling accident in 2010. The January 2012 Costa Concordia ferry accident may have wider repercussions for shipping insurance costs if it leads to a reappraisal of large cruise-liner design, although maritime accident rates remain extremely low.

The increase in payouts (expected to push the 2011 combined ratio above 100%) and new evidence on risk will trigger a rise in premiums for large-risk cover. This will extend to household policies - with premiums for buildings and contents set to rise by as much as 10% on average - even though milder weather led to fewer claims last year than in 2010. But there is no firm evidence of an upturn in the underwriting cycle, even though premium rises follow on from an erosion of capital since 2008. Despite taking their largest underwriting loss since 2001 as a result of record natural disaster liabilities, reinsurers say there is still sufficient capacity to absorb additional risks without raising new capital. Independent estimates put spare capacity at upwards of £20bn. In contrast to the US, where steady growth of premiums through the second half of 2011 has raised hope of an end to the down-cycle that began in 2004, UK insurers may have to prepare for an extension of the current cycle beyond the characteristic eight years. The unusually deep recession and slow recovery has limited the capacity of customers (especially smaller businesses) to absorb premium increases, raising the risk that some will respond to these by economising on cover to contain their overall spending.

...but premium rises will be difficult with the UK entering recession

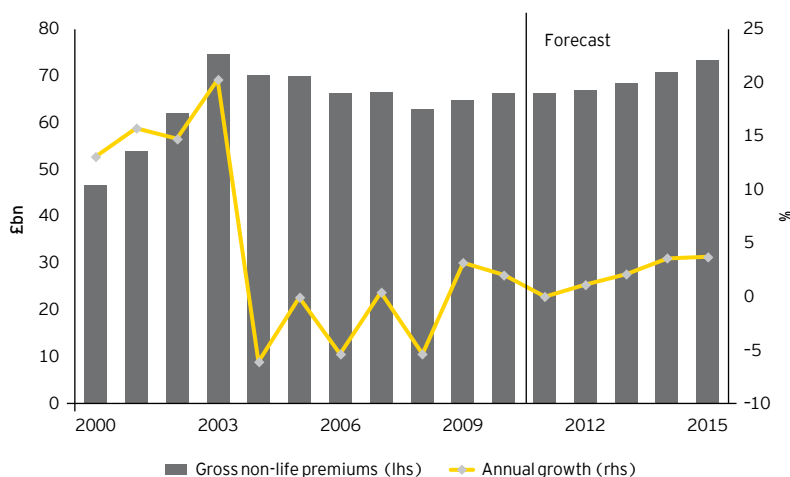
Within the UK, wind and flood damage in December 2011 triggered a sharp upturn in claims extending into 2012, of sufficient scale to require a rise in premiums. Some weather-related risks, especially related to flooding, appear to have been subject to previous under-estimation, which is becoming easier to correct as more local information becomes available. Premium rises will be restrained, however, by fear of customers switching to lower-cost competition, or reducing their level of cover because of its expense, especially in 2012-13 as household incomes remain squeezed. As a result, growth in gross non-life premiums is forecast at just 1.1% in 2012, rising to 2.1% in 2013.

The end-year upturn in weather-related claims exacerbated a longer-running problem arising from escalating claim costs for motor insurance, the largest non-life segment but one that has been unprofitable for a number of years. An Office of Fair Trading (OFT) enquiry has confirmed the extent to which additional claim costs have raised payouts on motor insurance despite a falling accident rate. Part of the increase arises from the pursuit of legitimate claims, promoted by claims management companies' willingness to pay referral fees. There is also evidence of more exaggerated or invented claims, which present anti-fraud measures have not been able to filter out.

Average premiums have risen as insurers aim to write motor insurance profitably, and this helped to reduce motor insurers' underlying net combined ratios below 120% in 2010. Although premium increases have been constrained by strong competition (reflecting ease of entry) in this segment, the consequent rise in insurance costs -, which has arguably led to motor insurance

Chart 2.3: Gross non-life premiums

Source: ITEM/Haver Analytics



being unaffordable for younger male and lower-income drivers – has brought the problem to political attention. This will ultimately work in insurers' favour by prompting legislative action against some of the factors that have inflated the number and cost of claims (with personal injury claims up more than 70% since 2002). The Transport Select Committee has proposed banning referral fees, and tightening the criteria for accepting claims for injury such as whiplash. Legal costs make up more than half the total cost of low-value personal injury motor claims, and new ways to settle these without litigation (which have been initiated in the UK for small-value claims and developed more widely in Ireland) could significantly reduce total payouts on legitimate claims. OFT research also indicates scope for reducing the standard allowance for courtesy-car hire. These measures will take time to implement, even though a political consensus is building behind them. Net combined ratios are forecast to come close to 100% in 2011, but for 2012 and 2013 a lot hangs in the balance depending on price competition and the claims inflation experienced. There is still scope for insurers to influence the overall result.

The difficulty in hardening premiums has become more serious because investment income – which more than bridged the gap for most of the decade to 2008 – is set to remain subdued for at least another year. UK insurers have eliminated serious exposure to Greece and reduced it against other vulnerable Eurozone economies, but while reducing portfolio risk, this has also eroded returns. A number of UK-based insurers have been notified of possible credit-rating downgrade (notably by Standard & Poor's in December 2011), mainly because of their exposures to Eurozone-periphery sovereign debt and to

comparably exposed banks. There remains a danger that insurers' generally large debt and equity holdings in banks could require them to raise more capital due to indirect exposure to Eurozone sovereign debt deterioration (and in the longer term, to the ICB's proposal for unsecured creditors to share the costs of future bank insolvencies with shareholders). This further reduces the chance of flexibility over Solvency II requirements, and points to a rise in the cost of providing long-term and large-risk policies that carry higher capital requirements. Meeting these will dampen the recovery of profits in line with faster growth in 2014-15.

Introduction of Solvency II may still provide challenges

Since its initial announcement, successive governments have negotiated to soften some of the capital requirements and other measures contained in the Solvency II regime, where these threatened to impact the UK industry particularly heavily because of its structure (especially its unusually large life assurance segment). With a year to go before Solvency II takes effect, the costs of full compliance have been brought down substantially, from the £50bn of additional capital that the ABI calculated in 2009. However, problems elsewhere in the financial sector have strengthened regulators' resistance to a further downward revision of capital requirements. These will cause a shakeout of smaller-market players, extending from providers to insurance brokers and other intermediaries, and a rise in price of some long-term products that will limit their sale.

The announcement of year-end results will be watched closely to see whether insurers maintain relatively high levels of dividend payouts (especially in the non-life segment)

Table 5: Insurance

Source: ITEM

	2010	2011	2012	2013	2014	2015
Total gross premium (£mn)	203,087	203,634	204,501	209,757	218,961	229,129
% year	0.6	0.3	0.4	2.6	4.4	4.6
Total gross claims payments (£mn)	155,924	147,412	147,252	149,837	152,447	154,464
Total claims ratio (%)	77	72	72	71	70	67
Life gross premium (£mn)	136,716	137,263	137,400	141,248	147,985	155,527
% year	-0.1	0.4	0.1	2.8	4.8	5.1
Life gross claims payments (£mn)	126,811	114,891	115,580	118,007	121,076	124,950
Life claims ratio (%)	93	84	84	84	82	80
Non-life gross premium (£mn)	66,370	66,370	67,101	68,510	72,976	73,602
% year	2.0	0.0	1.1	2.1	3.6	3.7
Non-life gross claims payments (£mn)	29,113	32,522	31,671	31,830	31,371	29,514
Non-life claims ratio (%)	44	49	47	46	44	40

in the face of an expected decline in net profits, mainly resulting from impairments on holdings of Greek sovereign debt and equities. In light of the ongoing changes to the Solvency II regime, it is possible that insurers will use these dividend payments to signal their financial health. On the other hand, the current high level of dividend payouts may also be an indication that insurance groups have fewer external growth opportunities, resulting in more free cash flow that can be made available to shareholders.

Asset management

Eurozone crisis is prompting withdrawals from equity funds...

Industry data shows that the rise in assets under management in the UK in the first half of 2011 was reversed in the second half of the year, as renewed volatility in financial markets resulted in a net outflow of funds. Retail sales of Investment Management Association (IMA) members dropped to their lowest level for three years in November, with equity funds most affected. While retaining some appetite for emerging-market equities, investors turned away from funds focused on Europe, the US and UK, including smaller companies.

After strong preference for balanced funds in the first half of 2011, retail inflows have since been mainly to bond funds, and existing portfolios have generally been reweighting from equities towards bonds. Despite the wide UK fiscal deficit, prices of government bonds have been supported by strong international demand, and purchases by the Bank of England, with a further £75bn of quantitative easing widely expected in early 2012. The consequent continuation of historically low yields on UK government bonds, and a diminishing number of AAA-rated sovereigns in the

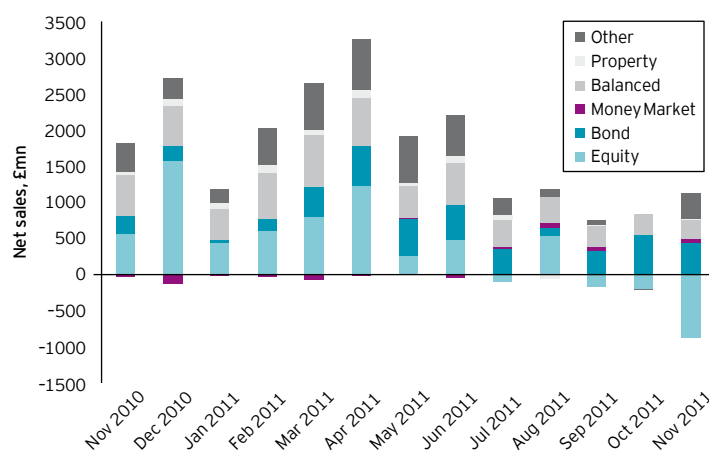
Eurozone, has pushed bond investors towards funds that can also access higher-yielding corporate bonds. The prospect of slower inflation in the first half of 2012 has added to bonds' appeal, although a general rise in funds' liquid asset holdings signals a readiness to re-enter equities once any correction has occurred. Subdued prospects for short-term returns on cautiously weighted funds, and anticipation of lower inflation, have increased households' inclination to keep savings on deposit that might previously have been channelled to fund investment. Banks' strategies (especially in the Eurozone) are tending to encourage this, as banks continue to try and close the customer funding gap by raising deposits in relation to loans, while also reviewing their role as fund and insurance sales channels.

...although the UK is benefitting somewhat from its 'safe haven' status

However, the UK was the only EU financial centre to enjoy net inflows to its UCITS (Undertakings for Collective Investment in Transferable Securities) funds in the third quarter of 2011, as it became a safe haven for international investors concerned about the intensification of the Eurozone sovereign debt crisis. EFAMA (European Fund and Asset Management Association) data put UK net UCITS sales at €11.9bn in the first three quarters of 2011, behind Ireland (€35.6bn) but ahead of Switzerland (€7.7bn). Meanwhile, Luxembourg experienced net outflows of €9.1bn over the same period. The movement of funds into the UK was assisted by expectations of short-term sterling appreciation, as a slowdown of growth and interbank lending forced the ECB to lower interest rates, and may also have reflected professional investors buying on perceived weakness after the equity market sell-off. While the

Chart 3.1: UK retail sales by sector

Source: IMA



UK attracted defensive inflows, European UCITS net sales declined throughout the second half, the main movement again being out of equities, but with bond and money-market funds also experiencing decline. This will reinforce the UK industry's focus on institutional funds as the main growth area in 2012-13, with retail business regaining strength only as EU economies return to stronger growth in 2014.

Inflows to UK-based absolute return funds also rebounded in the fourth quarter of 2011, reflecting confidence that their performance will recover after setbacks due to high correlation of alternative assets with equity performance earlier in the year. Hedge funds performed relatively well in 2011 but in most cases missed their target of positive absolute returns: fewer than 40% of the IMA's absolute-return funds achieved a positive return in 2011 (according to Morningstar), and globally these funds experienced an average decline of 4.8% (on Hedge Fund Research calculations). Confidence that they will regain an edge over funds with relative-return strategies, to justify their higher management charges, is based on the rarity of prolonged correlation, and funds' greater scope for profiting from falling as well as rising markets.

Although centralised settlement and disclosure requirements for derivatives trades (under the European Market Infrastructure Regulation, EMIR, and the US Dodd-Frank Act), and new requirements for disclosure of strategy, are regarded by some hedge-fund managers as 'giving their game away' to market disadvantage, others see ways to continue their strategy under new rules. So only a limited number of hedge funds have closed or narrowed to a core of private investors in order to escape the regulations, and many are adapting to continue operating under them. The

strong record of some long-established hedge funds will continue to attract retail investors to absolute-return funds as they become more readily available, although any difficulty in matching that record could make retention more difficult unless charges are also reduced.

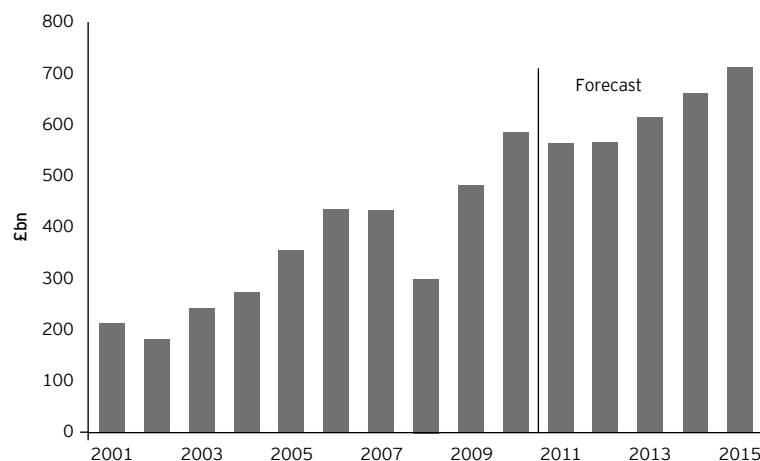
Sentiment is unlikely to turn quickly in 2012

Retail funds' difficulty in attracting net sales is forecast to continue throughout the first half of 2012, as unresolved Eurozone debt and banking problems continue to weigh on equity prices and slow growth in real incomes restrains investment inflows. Against this background, we forecast total assets under management to expand only marginally, by 0.4%, over the course of this year. But prospects look more positive from 2013, when financial market conditions should improve, prompting renewed inflows of funds. We expect growth in assets under management to average around 8% per annum during 2013-15.

From the end of the 2012, further challenges will arise from the implementation of new disclosure requirements under the Retail Distribution Review (RDR). Funds and independent financial advisers that distribute them will have to publish more detailed information on charges, indicating how these compare to fund values and enabling a calculation of their impact on returns on investment. Clearer presentation of fund charges is intended to promote competition to drive them down; but it may also turn some customers away from retail funds altogether. Smaller investors will be diverted from actively managed funds into lower-cost index-tracking funds, for which competition is set to intensify, especially if exchange-traded funds start to target the retail market.

Chart 3.2: Assets under management in the UK

Source: ITEM, Lipper FMI



Some active managers are preparing to offer lower-charge access routes in order to retain smaller clients who might otherwise switch to index funds, and return-focused clients who might otherwise be drawn into hedge funds. Launches of low-cost active funds will accelerate in 2012 as the new disclosure rules approach. But other managers are expected to move away from the retail market to concentrate on institutional clients more willing to pay higher fees for improved returns.

Regulatory developments are likely to raise transactions costs

Active managers' cost disadvantage would be further increased by imposition of a financial transaction tax (FTT); the FTT would hit high-frequency traders disproportionately, but this would also impact passive funds because of their need to make rebalancing trades when share prices change, so fund managers will continue to lobby against it, via EFAMA and other trade associations.

Even if an FTT is watered down or avoided, the long post-deregulation trend of falling transaction costs could be interrupted by other regulatory developments. Proposed new rules for orderly and transparent trading on electronic exchanges, published by the European Security and Markets Authority (ESMA) with a consultation period ending in January, will take effect in May and will impose new duties on operators - including the detection and prevention of disorderly or manipulative trades, and the checking of clients' IT systems along with any automated trading programs they use. These new rules for the main exchanges will arrive ahead of similar requirements (under EMIR) for derivatives trades, creating exchanges for those previously conducted over-the-counter.

Shift toward emerging markets likely to be only gradual

Although economic growth in large Asian and Latin American emerging markets will remain above that of Europe and North America through 2012-15, this will prompt a gradual portfolio widening rather than a significant shift from 'old' into 'new' world stocks. Corporate profitability and distribution prospects remain strong in the UK and North America despite slow-growing economies, with many non-financial companies sitting on cash piles that could be returned to shareholders. Underdeveloped financial markets make many of the more dynamic emerging economies (including China) relatively difficult and expensive to access, with accounts still making it difficult to identify the best-performing stocks. Demand for funds specific to emerging economies grew only marginally in 2011, and the emphasis in 2012-13 is expected to remain on diversified funds that assemble shares and bonds across a wide region, seeking to extend equity exposure geographically until EU and US equity markets show firm recovery signs.

Further industry consolidation appears likely

With fund-management costs set to rise while competition and transparency regulations restrict the scope to pass on the increases, at least one EU banking group is considering the sale of its retail asset-management units. This will add to forces for consolidation within the retail sector, with some smaller funds also seeking to amalgamate or be absorbed into larger units. The present large variety of funds, which proliferated during much more positive times in mainstream equity markets, is set to narrow into fewer, larger units that can spread fixed costs over more clients, and meet the demand for increasing diversification across asset classes and geographies.

Table 6: Asset management

Source: ITEM, Bank of England

	2010	2011	2012	2013	2014	2015
Total assets under management (£mn)	588,290	566,500	568,533	616,847	664,104	715,061
% year	21.6	-3.7	0.4	8.5	7.7	7.7

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