Outlook
for financial services

Summer 2017

ey.com/fsitemclub

About this report

The *EY ITEM Club: Outlook for financial services* examines the implications of the EY ITEM Club's economic projections for the financial services sector. EY is the sole sponsor of the EY 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.

In conjunction with ITEM's Chief Economist Howard Archer, Oxford Economics is responsible for producing the forecasts and analysis provided in ITEM's forecast reports. Oxford Economics is one of the world's foremost independent providers of global economic research and consulting using unique global economic models.

Contents

04
Macroeconomic overview

06
Banking

08
Insurance

10
Wealth & Asset Management

Macroeconomic overview

Economic growth has eased and is likely to remain sluggish

Economic growth exceeded the expectations of many forecasters in the second half of 2016, but has put in a weaker performance since the turn of 2017. Gross Domestic Product (GDP) expanded by 0.3% in the first quarter of this year compared to 0.7% in Q4 2016. And whilst the rate of expansion looks to have picked up in Q2, headwinds from elevated inflation and political uncertainty point to a relatively sluggish period of economic growth by historical standards. Having expanded by 1.8% in 2016, GDP growth is forecast at 1.5% this year and 1.3% and 1.8% in 2018 and 2019 respectively.

Consumers will continue to suffer from the consequences of higher inflation...

With consumer spending representing around 60% of GDP, the squeeze on households' spending power from rising inflation represents the biggest threat to the economy's short-term prospects. Inflation is forecast to peak at just over 3% in the second half of this year, which would be the highest rate since 2012. Given pay growth is still subdued, this implies a year of falling real earnings, which are forecast to drop by 0.5%.

Meanwhile, with the proportion of the working-age population not in employment currently standing at a record low, arithmetic suggests that there is less scope for the employment rate to rise further. This, combined with the cuts to the welfare budget, will take a toll on disposable income. The ITEM Club forecast is for real household disposable income to fall by 0.2% this year, the first drop since 2013. Consumer spending is forecast to rise by 1.9% in 2017 and 1% in 2018, down from a stronger growth rate of 2.8% in 2016.

↑1.5%

GDP

GDP expanded by 0.3% in Q1 of this year compared to 0.7% in Q4 2016. GDP growth is forecast at 1.5% this year and 1.3% and 1.8% in 2018 and 2019 respectively.

↓0.2%

Household disposable incomes

Real household disposable incomes are forecast to fall by 0.2% this year, the first drop since 2013.

↑3%

Inflation

The squeeze on households' spending power from rising inflation is the biggest threat to the economy's short-term prospects. Inflation is forecast to peak at just over 3% in H2 2017, the highest rate since 2012.

…but the weak pound and prospect of a transitional Brexit deal offer some upsides

Although business investment rose in Q1 2017, the increase was modest and followed a sharp fall at the end of 2016, with Brexit-related uncertainty potentially playing a role in this weakness. This year, record corporate profitability, low interest rates on corporate borrowing and companies' high level of cash balances offer some reasons to be optimistic. But headwinds from the weaker consumer spending power, and uncertainty stemming from the UK's ultimate Brexit destination, mean that we still expect investment to broadly stagnate this year and next. However, the assumption of a more transitional Brexit deal points to a bounce-back from 2019 onwards.

Recent business surveys have been particularly upbeat on exports, reflecting the consequences of last year's drop in the pound and a more buoyant world economy. For the next two years at least, UK exporters are facing no additional barriers as a result of Brexit, leaving firms in a 'sweet spot'. This points to fairly strong export growth in the near term, with net trade forecast to add just under 0.5 percentage points to GDP growth this year and next. But the possibility that sterling could stage a strong recovery were the Brexit negotiations to proceed smoothly represents a risk here.

Brexit uncertainty should encourage the Monetary Policy Committee (MPC) to sit on its hands for now

The MPC has recently adopted a more hawkish tone than of late, reflecting above-target inflation and an economy that has continued to grow, albeit modestly. With persistent drivers of inflation, notably pay growth, expected to stay very subdued, and uncertainties around the Brexit process in play, there seems to be no pressing reason for the MPC to raise rates until the second half of 2018.

£435b

Business lending

Net business lending predicted to stagnate in 2018 and 2019 before slowly climbing to £435b by 2020.

↑5.4%

Consumer credit

Consumer credit still rising but growth rate likely to cool from high of 8% in 2016 to 5.4% in 2017.

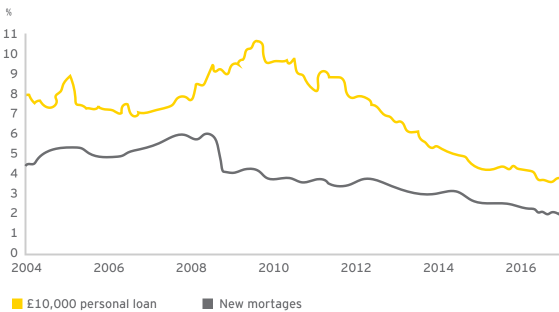
Banking

Pressures on household budgets likely to translate into slower lending growth...

Financial pressures on UK households will be a key driver of the outlook for the UK banking sector over the next few years. Households' appetite to take on more debt has already shown signs of cooling in recent months. The jobs market is forecast to weaken, growth in consumer spending and housing transactions are expected to slow as the squeeze on spending power from higher inflation continues, and so a slowdown in overall lending growth is likely.

Because we still think it is unlikely the Bank of England will raise interest rates until well into 2018, record low mortgage rates should continue to support the housing market. However, increasingly stretched affordability points to transactions and mortgage lending expanding at a more modest rate. The ratio of house prices to household incomes is currently just over 4.5, up from 3.7 in 2012 and not far off the record high of 4.8 reached in 2007. Having increased 4.4% in 2016, growth in the stock of mortgage lending is forecast to slow to 2.8% this year before dipping 0.6% in 2018.

Borrowing costs have hit record lows



Source: EY ITEM Club/Haver Analytics, July 2017

We expect a slowdown in the double-digit growth rates for consumer credit seen since the middle of last year. Admittedly, inaction on the part of the MPC and competition amongst lenders mean that record low interest rates on the £200b of car loans, personal loans and credit card debt held by UK households are unlikely to increase significantly any time soon. And pressure on real incomes from higher inflation may see some households make more use of credit to compensate. But squeezed real incomes may also dampen the appetite for debt. And with dealership car finance having seen the strongest growth among different components of credit growth in the last few years, our forecast of a decline in new car registrations will push down demand for this element of credit. Registrations are forecast to drop from a record high of 2.69m in 2016 (30% up on the level in 2012) to 2.58m this year and 2.42m in 2018.

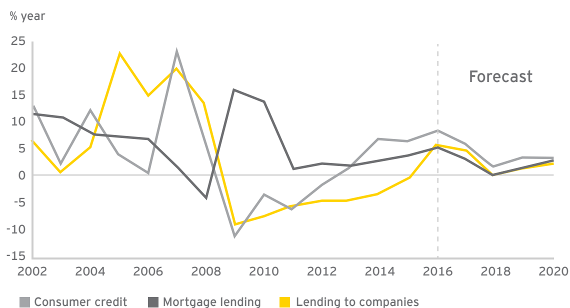
...as might regulatory moves

Recent moves by regulators suggest a desire to slow credit growth in the interests of financial stability. June saw the Bank announce a rise in capital requirements on banks via the "countercyclical capital buffer". The PRA published the findings of its review into the credit quality of new consumer lending in July, concluding that the resilience of consumer credit portfolios is reducing and asking lenders how they will mitigate the risk of losses on exposures. Meanwhile, the FCA is examining rules on creditworthiness assessments used in the consumer credit market. Whilst the Bank had been due to report on lenders' exposure to consumer credit as part of annual stress tests in November, this issue will be now be considered when the Financial Policy Committee meets next in September. Overall, we still expect consumer credit to grow 5.4% this year, down from 8% in 2016.

Business finance may see some shift back towards banks

Meanwhile, the conclusion of the Bank of England's programme of corporate bond purchases in April and the removal of the support this offered to the bond market should reduce the relative attractiveness of bond finance and may see some shift in business financing towards bank loans. Interest rates on corporate lending being at historically low levels should also support demand for bank financing relative to bonds. The average interest rate on a new corporate loan was just under 2.4% in April compared to 2.8% 12 months earlier and almost 7% just before the financial crisis struck. Since our last forecast, we have factored in a transitional Brexit deal and that means that the outlook for business lending is positive. The stock of lending to firms is forecast to rise 4.4% this year compared to 4.9% in 2016, before stagnating in 2018.

Growth in stock of lending set to slow



Source: EY ITEM Club/Haver Analytics, July 2017

Low interest rates and end of Term Funding Scheme (TFS) will squeeze margins for banks, although Payment Protection Insurance (PPI) payments have dropped

Economic growth continues to be modest, and with historically low loan-loss rates, demand for lending will help maintain growth in banks' income. In addition, misconduct costs continue to decline. Compensation payments for mis-sold PPI insurance have shown some tailing off in recent months (an average of £232m per month this year compared to £302m in 2016) and the FCA has now set a firm deadline for claiming compensation of August 2019, which at least provides some certainty to banks as to when this cost will end.

However, with the Bank of England unlikely to raise rates until well into 2018, pressure on banks' net interest margins will persist. The Bank of England's TFS, which provides lenders with cheap financing, is also coming to an end in early 2018, and should squeeze margins further. The implementation of IFRS 9 next year also represents a downside risk to banks' willingness to lend, were it to compel lenders to make bigger provisions for certain loans.

In summary, a softer economy means that UK retail banks are likely to face a less benign environment than of late, with the potential upside from higher interest rates and bigger net interest margins still some way off.

Banking sector recap

	2015	2016	2017	2018	2019	2020
Total assets (£b)	6,289	7,011	7,251	7,228	7,273	7,435
Total loans (£b)	5,419	6,089	6,299	6,258	6,332	6,482
Business/corporate loans (£b)	387	407	425	424	427	435
Write-offs (% loans)	*0.7*	*0.5*	*0.7*	*0.7*	*0.7*	*0.6*
Consumer credit (£b)	179	193	204	206	212	218
Write-offs (% loans)	*2.0*	*1.6*	*1.8*	*1.8*	*1.7*	*1.6*
Residential mortgage loans (£b)	1,110	1,159	1,192	1,184	1,196	1,226
Write-offs (% loans)	*0.04*	*0.01*	*0.01*	*0.02*	*0.02*	*0.02*
Deposits (% year)	-2.1	8.2	0.9	1.8	4.0	4.8
Loans/deposits (%)	129	134	138	139	138	138
Total income (£b)	128	134	137	137	139	143

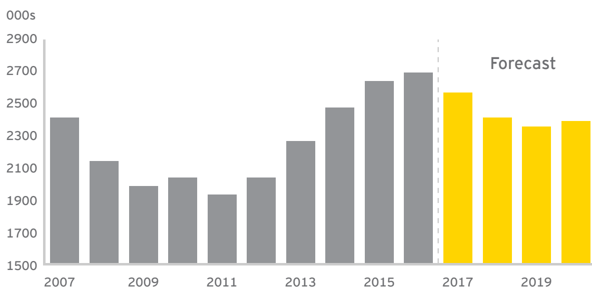
Source: ITEM, July 2017

Insurance

Pressure on household finances will impact non-life premium growth...

Alongside the slow burn effects of the Brexit vote, in particular, what the potential loss of EU 'passporting' might mean, the UK insurance sector is confronted with several macroeconomic challenges. The fact that the growth in earnings is relatively weak, alongside high inflation by recent standards means that household incomes are forecast to decline this year by 0.2% and grow only modestly thereafter. This will depress demand for big ticket purchases and therefore, hit non-life insurance premium growth. Car registrations are forecast to decline from a record 2.69m in 2016 to 2.58m this year and 2.42m in 2018, whilst annual growth in housing transactions is forecast to average 2.6% from 2017 to 2019, compared to 7% in the previous five years.

Car registrations to dip from 2016's record high



Source: EY ITEM Club/Haver Analytics, July 2017

...whilst policy measures represent further headwinds

General insurers also face policy headwinds. A further rise in Insurance Premium Tax (IPT) from 9% to 12% took effect in June 2017, representing a doubling of the rate in 18 months. Meanwhile, although the Government promised an emergency review into February's cut in the Ogden discount rate from 2.5% to -0.75%, the recent general election has delayed the timing of this review. So even if the Government ultimately rows back on the extent of the rate cut, insurers potentially face a period of higher pay-outs than they had expected. Moreover, legislation to reduce whiplash claims, which should have mitigated the consequences for premiums of the Ogden reform, has also been delayed by the election. We are still waiting to see what the impact of the new transparency regulation will be on insurers business as since April, they have been required to include the price of previous year's policy on each renewal quote.

That said, pressures on general insurers' profitability will be mitigated by an upswing in the insurance pricing cycle, evidenced by rising premiums. The price of car insurance rose 11.6% in the three months to May compared to a year earlier, the fastest increase in six months and more than four times the rate of overall consumer price inflation. Some of this increase reflects the further IPT rise from 9% to 12%, which took effect in June 2017, representing a doubling of the rate in 18 months. But prices are rising beyond the level needed to pass IPT rises onto consumers, marking a turning point in the insurance cycle. Overall, our latest forecast shows non-life premium income growing by around 3% in 2017 and 2018, compared to 2.6% in 2016.

Asset market developments should support the life and pensions sector

On the life and pensions side, continued rises in equity prices have favoured the sector. With the world economy looking more buoyant, the outlook for equities remains positive. In terms of the more important fixed-income element of insurers' assets, whilst we still think a rate rise is still some time away in the UK, a recent hawkish shift in the MPC's thinking along with a general move towards tighter monetary policy across many advanced economies is likely to put upward pressure on bond yields, boosting incomes. Indeed, as of July, 10-year gilt yields at 1.4% were double the level of last summer. We expect the 10-year gilt yield to average 2.5% from 2017 to 2020.

Insurance company profits dropped to £6.6b in 2016, down from £9.2b the previous year. We think profits will broadly stabilise around this level over the next few years, reflecting the conflicting effects of a weaker economy versus a recovery in long rates and the benefits of the weaker pound in pushing up the sterling return on insurers' overseas investments.

But there are risks to this outlook. Pressure on the Chancellor to find new sources of revenue to ease austerity in public spending could result in further restrictions on pension tax relief for high earners, to the detriment of the life and pensions sector. And life and pensions insurers are contemplating large scale investment in modernisation to adopt digital technology, respond to regulatory reviews, address ageing back book infrastructure and respond to new regulation such as IFRS 17. This investment expenditure is likely to put pressure on profits over the next few years.

Insurance sector recap

	2015	2016	2017	2018	2019	2020
Life gross premium (£b)	161.4	168.9	175.6	181.8	189.3	197.9
% year	-0.8	4.7	4.0	3.5	4.1	4.6
Life gross claims payments (£b)	159.9	164.1	169.7	172.2	175.7	179.9
Life claims ratio (%)	99	97	97	95	93	91
Non-life gross premium (£b)	58.9	60.5	62.3	64.2	65.8	67.9
% year	-0.3	2.7	3.1	3.0	2.5	3.2
Non-life gross claims payments (£b)	30.4	31.0	33.2	33.9	34.3	34.9
Non-life claims ratio (%)	52	51	53	53	52	51
Net profit (£b)	9.2	6.6	6.5	6.7	7.0	7.4

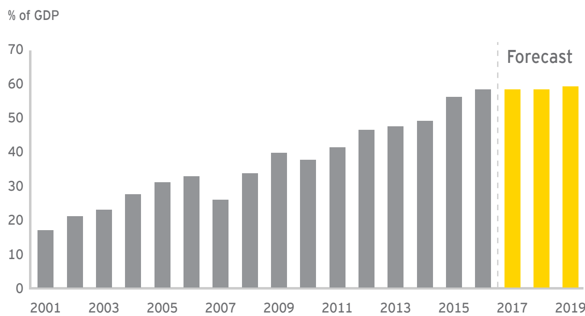
Source: ITEM, OECD, Swiss Re, July 2017

Wealth & Asset Management

Total UK assets under management (AUMs) amounted to almost £1.1t at the end of 2016, equivalent to 56% of UK GDP. Spurred by strong growth in global equity markets and the boost to the value of overseas assets provided by sterling's post-referendum drop, this represented a 16.3% rise from 2015's £930b, the biggest annual percentage increase since 2010.

With the world economy looking healthier than at any time since just before the financial crisis, the UK economy forecast to continue growing slowly, a continued ageing in the population and escalating auto-enrolment rates for employees, we expect AUMs to continue rising and reach £1.3t by 2020. UK households' net financial wealth being close to a record high in the first quarter of 2017, equivalent to just over 370% of household income, should also bolster sentiment towards the sector.

AUMs reached almost 60% of GDP in 2016 and are forecast to climb further



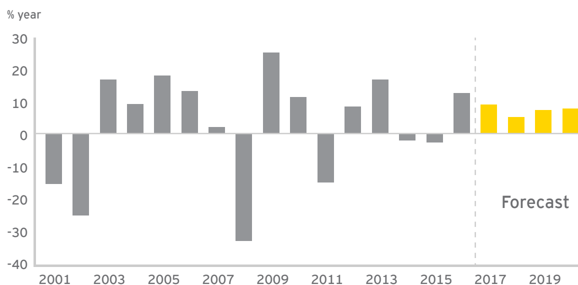
Source: EY ITEM Club/Haver Analytics, July 2017

The sector is likely to continue seeing large asset flows between providers as wealthy over-55s consolidate their retirement assets, but also a smaller but steadily growing stream of genuine new inflows from escalating auto-enrolment contributions. Some customers might opt out as contributions rate rise, but inertia means they are unlikely to do it without a triggering event such as changing jobs.

In terms of asset allocation, the likelihood of further rises in US interest rates this year and a tapering of the European Central Bank's asset purchase programme may weigh on bond prices and the attractiveness of this asset class. At the same time, higher long-term rates globally may dampen the 'search for yield' that has been so prevalent in the investment world during the last decade. Our assumption that the Bank of England will not be raising interest rates in the UK until well into 2018 should support the appeal of gilts in the near-term. Overall, we expect bonds' share in UK AUMs to see a modest decline, from 15.2% in 2016 to 13.8% in 2020.

The proportion of AUMs held in equities dipped slightly from 50.8% in 2015 to 49.7% in 2016. Recent signs of a pickup in global growth and our forecast that sterling's value will remain relatively depressed should benefit UK equity prices and raise equities' share of AUMs. Following a 12.5% rise in 2016, the FTSE All-Share Index is forecast to climb a further 8.8% this year. Growth should then slow, as the expansion in the global economy moderates and a forecast recovery in sterling weighs on the valuations of internationally-orientated UK companies. We forecast equities under management to rise by just under 6% per year from 2017 to 2020.

FTSE set for a reasonable performance in the near-term



Source: EY ITEM Club/Haver Analytics, July 2017

Meanwhile, the desire for diversification in a world of increased economic and political uncertainty and greater freedom in retirement income choice should continue to support demand for fund-of-fund and mixed funds. Rising interest rates globally should boost the attractiveness of money market funds.

The suspension of seven large property funds following last year's EU referendum means that we continue to take a less optimistic view of prospects for this AUM sub-sector. Although the funds were all later reopened, shaken confidence in the sector, along with perceptions of a stretched property market, are forecast to see AUMs broadly stagnate over the next few years.

Wealth & Asset Management sector recap

	2015	2016	2017	2018	2019	2020
Total assets under management (£b)*	932	1,084	1,174	1,201	1,242	1,299
% year	*7.7*	*16.3*	*8.4*	*2.3*	*3.4*	*4.5*
Bonds (£b)	145	165	176	179	181	183
Equity (£b)	474	538	588	598	620	651
Fund of funds (£b)	113	133	145	151	159	169
Hedge (£b)	1.4	1.3	1.2	1.2	1.2	1.3
Mixed (£b)	133	159	171	177	185	197
Money Market (£b)	35	59	65	67	67	67
Property (£b)	31	28	28	29	29	30

*UCITS and non-UCITS assets

Source: ITEM; Lipper FMI, July 2017

EY | Assurance | Tax | Transactions | Advisory

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organisation, and may refer to one or more of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organisation, please visit ey.com.

EY is a leader in serving the financial services industry

We understand the importance of asking great questions. It's how you innovate, transform and achieve a better working world. One that benefits our clients, our people and our communities. Finance fuels our lives. No other sector can touch so many people or shape so many futures. That's why globally we employ 26,000 people who focus on financial services and nothing else. Our connected financial services teams are dedicated to providing assurance, tax, transaction and advisory services to the banking and capital markets, insurance, and wealth and asset management sectors. It's our global connectivity and local knowledge that ensure we deliver the insights and quality services to help build trust and confidence in the capital markets and in economies the world over. By connecting people with the right mix of knowledge and insight, we are able to ask great questions. The better the question. The better the answer. The better the world works.

Ernst & Young LLP

The UK firm Ernst & Young LLP is a limited liability partnership registered in England and Wales with registered number OC300001 and is a member firm of Ernst & Young Global Limited.

Ernst & Young LLP, 1 More London Place, London SE1 2AF.

© 2017 Ernst & Young LLP. Published in the UK.
All Rights Reserved.

EYG no. 04669-174Gbl

In line with EY's commitment to minimise its impact on the environment, this document has been printed on paper with a high recycled content.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. Please refer to your advisors for specific advice.

ey.com/ukfs

About Oxford Economics

Oxford Economics was founded in 1981 to provide independent forecasting and analysis tailored to the needs of economists and planners in Government and business. It is now one of the world's leading providers of economic analysis, advice and models, with over 700 clients including international organisations, Government departments and central banks around the world, and a large number of multinational blue-chip companies across the whole industrial spectrum.

Oxford Economics commands a high degree of professional and technical expertise, both in its own staff of over 80 professional economists based in Oxford, London, Belfast, Paris, the UAE, Singapore, New York and Philadelphia, and through its close links with Oxford University and a range of partner institutions in Europe and the US. Oxford Economics' services include forecasting for 200 countries, 100 sectors and 3,000 cities and sub-regions in Europe and Asia; economic impact assessments; policy analysis; and work on the economics of energy and sustainability.

The forecasts presented in this report are based on information obtained from public sources that we consider to be reliable but we assume no liability for their completeness or accuracy. The analysis presented in this report is for information purposes only and Oxford Economics does not warrant that its forecasts, projections, advice and/or recommendations will be accurate or achievable. Oxford Economics will not be liable for the contents of any of the foregoing or for the reliance by readers on any of the foregoing.