EY ITEM Club Outlook for financial services

Minds made for empowering financial services

Autumn 2020

EY

Building a better working world

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.

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, consulting, strategy, tax and transaction services to the banking and capital markets, insurance, and wealth and asset management sectors. It's our global connectivity and local knowledge that ensures 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.

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Foreword

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Economists do not have an easy job, particularly at the moment, with economic fundamentals such as borrowing, consumer spending and consumer confidence changing rapidly. I'm afraid the risks to our latest *EY ITEM Club Outlook for financial services* are to the downside; the forecast is based on the assumption that a Brexit deal will be reached at the end of the year, and that more normal economic conditions will return in 2021 with a gradual relaxation of COVID-19 restrictions, both of which are currently hanging in the balance.

As we fast approach the end of the Brexit transition period, firms don't yet have a clear view on what a future trading relationship with the EU, and many other significant trading partners will look like, although the progress made in securing a trade deal with Japan is encouraging. Additionally, it's unclear how long the current lockdown restrictions will last, and what potential future virus control measures there may be.

The headlines from our latest EY ITEM Club outlook are downbeat: despite a bounceback over the summer, the forecast is for a record 10% decline in gross domestic product (GDP) across 2020; unemployment is forecast to rise to over 7.5% early next year; and consumer spending is forecast to fall by 12.8% across 2020. 2021 is set to be better, but both GDP and consumer spending will only partially recover.

The Government continues to provide unprecedented levels of much-needed support to the economy, but rising unemployment and the replacement of the Furlough Scheme with the Jobs Support Scheme, will ultimately reduce the amount of money in consumers' pockets, which impacts their ability to service existing debt and make new purchases. In response, both the financial services industry and the regulators have put further support measures in place to help customers and businesses with their financial resilience. Rising unemployment and the ongoing challenges faced by small businesses in many sectors will mean the outlook remains testing.

Financial services firms entered this crisis in a position of capital strength and have played a critical role since the UK went into lockdown, giving unprecedented support to businesses and the wider economy. Numbers out from the Treasury on 22 October 2020 show that banks have supported £62b of lending from Government schemes to date. The total stock of bank lending to businesses is forecast to reach £493b at the end of 2020, which is a huge 11% year-on-year increase.

To view this from a different angle, UK firms' net borrowing this year is expected to be around five times higher than the amount borrowed in 2019, with many firms predicted to only start repaying this debt and reducing their borrowing from 2022. And our forecast shows that banks will continue to lend next year to support business and growth in the UK economy, with the EY ITEM Club predicting business lending growth of more than 5% in 2021.

But the banking sector is facing a multitude of challenges, including squeezed interest margins and increased write-offs on loans. Total business loan losses are forecast to rise from 0.3% in 2019 to 0.4% and 0.5% this year and the next, as some businesses struggle to meet their loan repayments. And new lockdown restrictions could see borrowing levels rise even further, and subsequently the potential for loan losses to increase.

Meanwhile, consumer credit is forecast to see the biggest fall in nine years in 2020 — nearly 6% — with only a slow recovery of 0.5% growth in 2021. Whilst it remains to be seen how consumer confidence will evolve, local lockdown restrictions and a forecasted steep rise in unemployment are likely to further negatively impact growth, placing additional pressure on banks.

One area where reasonable growth is forecast is mortgage lending. Despite the economic challenges, mortgage lending growth of 3.2% and 3.4% is forecast this year and next, due to the temporary cut in stamp duty, very low mortgage rates and savings accumulated during lockdown helping to fund property deposits and trading-up. However, new lockdown restrictions — and the potential for more to come — present a risk to our forecast.

The rest of the financial services industry is also feeling the effects of the economic impact from COVID-19. Insurers are facing multiple challenges this year and asset managers are contending with a fall in assets under management (AUM) — 2020 is forecast to see the value of UK asset managers AUM decline by 1.5%, a stark contrast to the growth of 11.6% seen in 2019.

COVID-19, continued Brexit uncertainty and climate change risk are a potent combination of both short-term and long-term challenges for the financial services sector. But if there's one thing this forecast shows, it is the inter-relation between the macroeconomic forecast and the role of the financial services industry in getting credit to consumers and small businesses, supporting households in their savings — and accessing those savings — and the insurance sector's support to businesses and consumers in difficult times. Over the next few years the UK needs a healthy financial services sector, so it can remain focused on supporting the economy through short-term volatility and uncertainty, as well as ensuring the country retains its place as a world-leading financial services centre post-Brexit such that it can help build back a better Britain.

Macroeconomic overview

The record decline in GDP from the immediate fallout of the COVID-19 pandemic seemed short-lived following the relaxation of lockdown restrictions over the Summer of 2020, which caused a strong economic rebound. With the immediate benefits of reopening the economy now in the past, the pace of growth is expected to slow significantly over late 2020 into early 2021.

Q2 saw a record decline in GDP, with Q3 predicted to have seen a record rise

Following a 2.5% drop in GDP in the first quarter of 2020, the full economic impact of the COVID-19 pandemic and public health response manifested in a 19.8% decline in Q2 — the biggest fall since records began. The gradual relaxation of lockdown restrictions from mid-May generated a strong rebound, with GDP rising by 2.7%, 9.1% and 6.4% in May, June and July respectively. Although monthly growth slowed to 2.1% in August, the rise in GDP and evidence from the monthly Purchasing Managers Index (PMI) surveys and high-frequency data, such as retail footfall and road traffic, point to GDP rising by 17% in Q3.

Despite this rapid recovery, GDP in September is likely to have remained 9% below its level in Q4 of 2019. The pace of growth is also expected to slow significantly to just under 1% in Q4 2020 as post-lockdown release of pent-up demand fades, and new social distancing measures and local restrictions introduced by the Government across September and October, drag on activity. With these factors in mind, GDP is forecast to fall by a total of 10% across 2020 — with a 6% rise in 2021 — alleviating the loss to a small degree.

Consumer outlook is overshadowed by the prospect of increased unemployment and weak sentiment…

Consumer spending has recovered strongly since the easing of lockdown restrictions. Retail sale volumes in August exceeded February's pre-pandemic level, and car registrations over the Summer were up year-on-year. However, these economic benefits reflect the release of pent-up demand and the outlook is overshadowed by uncertainty over consumer behaviour as Government stimulus is withdrawn and conditions eventually return to normal. A spike in unemployment is forecast as the Government's Furlough Scheme is replaced by the less generous Jobs Support Scheme — weighing on both incomes and sentiment. Nonetheless, spending should be supported by some consumers saving record amounts during the lockdown period as well as low inflation rates — albeit this will apply more so to affluent households. Overall, the EY ITEM Club expects consumer spending to drop by 12.8% across 2020, then rebound by 7.6% in 2021.

…while investment looks set for a slow recovery

Business investment fell by over a quarter in Q2, with a likely rebound in Q3 supported by the reopening economy. Nonetheless, firms have likely delayed spending and investment to conserve cashflow in the face of uncertainty — amplified by a lack of clarity around the UK and EU Brexit trade deal. This trend, however, is unlikely to be reflective of all sectors. For example, investment across online retailing should continue to increase given the recent shift in consumer spending patterns.

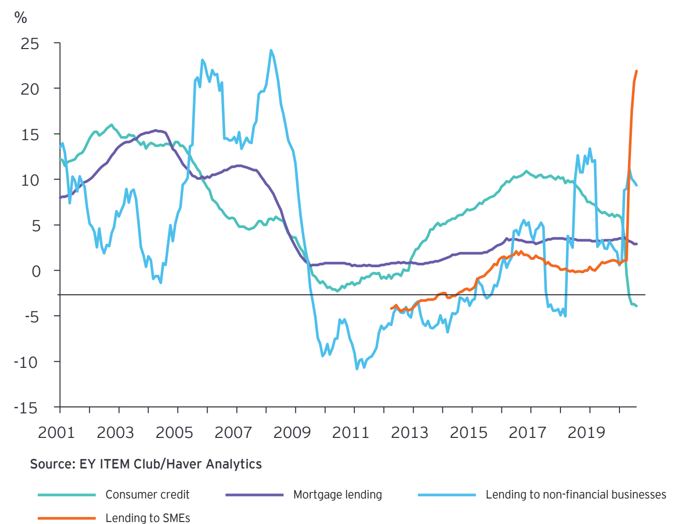
Interest rates will continue to remain low

The Monetary Policy Committee (MPC) cut Bank Rate to 0.1% in March and restarted quantitative easing. The Bank of England (BoE) purchased £200b of assets earlier this year and is currently in the process of buying an additional £100b of Government and corporate bonds, to be completed by the end of the year. Recent commentary from MPC members suggest they would vote for more asset purchases should the pace of recovery disappoint. The option of cutting interest rates into negative territory has also been suggested — but given the drawbacks, it is expected that the committee will not take this option, short of a renewed downturn.

Banking

The relaxation of social distancing measures prompted a recovery in lending to households and a mini housing market 'boom,' leaving mortgage lending relatively unmarked by the pandemic. However, a fall in consumer credit is forecast over 2020, reflecting the prospect of heightened unemployment and consumer caution — leaving individuals' appetites for debt persistently impaired. During lockdown, firms borrowed heavily as revenues subsided, but have since held back on demand for credit to limit being faced with debt — the reverse of the usual pattern seen from economic recovery. Slower growth of 5.2% is forecast for business lending in 2021.

The COVID-19 crisis drove down lending to households but saw business lending surge



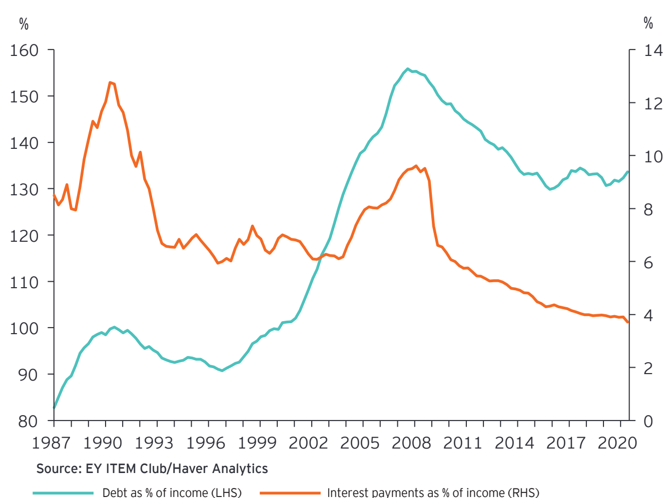
The economic impact of the COVID-19 pandemic will likely prompt a rise in loan-losses. For example, the Department for Business's 2019-2020 annual report and accounts highlight likely total credit and fraud losses of between 35% and 60% for the Bounce Back Loan Scheme (BBLS). Assuming the Scheme lends £43b, this would imply a potential cost to Government of £15b to £26b.

Mortgage lending may prove relatively resilient to economic difficulty...

Both the housing market and mortgage lending were hit hard by the national lockdown. Mortgage approvals fell to only 9,285 in May — almost a 90% decline from February's level, and around a third of their trough during the financial crisis in 2008 — a period which previously stood out for the scale of the fall in mortgage demand. Net mortgage lending averaged only £1.1b over April and May, compared to around £4b per month at the start of the year.

Post-lockdown, activity grew rapidly helped by a release of pent-up demand, July's temporary cut in Stamp Duty, record low mortgage rates, and household interest burdens. Mortgage approvals reached 84,700 in August, the highest number since October 2007 — well above the 66,200 averaged over the three years to 2019. However, this only partially offset weakness between March and June. The first eight months of 2020 saw 418,000 approvals, compared with 524,000 in the same period in 2019, and although net mortgage lending climbed to £3.1b in August, this was still a quarter down on the pre-pandemic level.

BoE's rate cuts have helped drive household interest burden to a record low



Looking ahead, the housing market may prove relatively resilient to a difficult economic outlook. Although we expect the unemployment rate to rise to over 7.5% early next year, up from 3.9% pre-pandemic, job losses are likely to be concentrated amongst younger, and lower-paid workers — a demographic bracket which most homeowners and potential property purchasers do not fall into. In addition, the substantial savings accumulated by more affluent households during the lockdown could provide the resources to fund property deposits or help towards trading-up. The household saving ratio rose to a record high of 29.1% in Q2 2020, surpassing the previous record of 14.4% in 1993. Overall, the EY ITEM Club forecasts the stock of mortgage lending to rise by 3.2% this year, with growth of 3.4% in 2021.

...but a rebound in consumer lending faces economic challenges

Net lending via credit cards and personal loans turned negative during the lockdown period as people repaid a total of £15.4b of consumer credit from March to June, the first net repayments since 2011. Although net lending turned positive over June and July, a monthly average of £0.7b was below 2019's £1.1b. Annual growth of − 3.9% in August was the weakest since the series began in 1993.

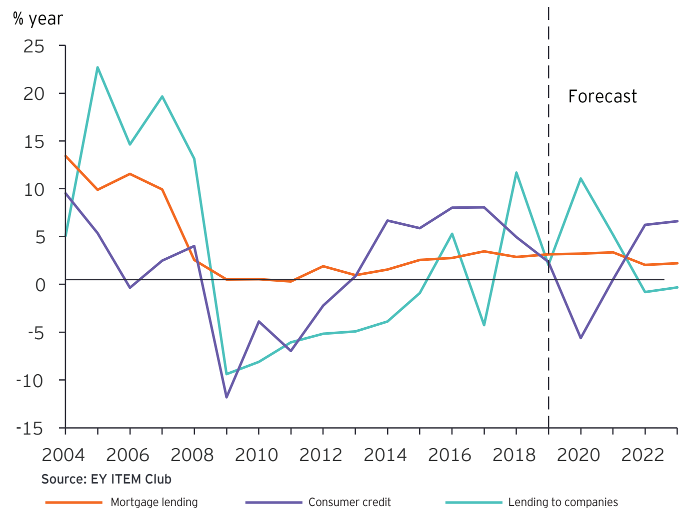
The possibility of some households financing big-ticket purchases using lockdown savings, rather than credit, suggests that a rebound in consumer lending could remain subdued. Greater consumer caution, particularly in light of recent social distancing restrictions and the transition to the less generous Job Support Scheme, may also weigh on demand for credit. These economic barriers, combined with the steep fall in consumer credit during the lockdown, lead to a forecast decline in credit by 5.6% across 2020, the biggest fall since 2011. 2021 is forecast to see growth of 0.5%.

Businesses are likely to focus on balance sheet repair

Lending to the corporate sector surged during lockdown as many firms took advantage of Government-subsidised lending schemes. Net of repayments, banks lent non-financial companies just over £34b in March – almost 50 times the average monthly net lending in 2019. Lending continued at historically high levels over April and May, resulting in annual growth in corporate loans accelerating from 0.6% in February to 11.1% in May.

However, net business lending fell back over June, July and August, suggesting that some earlier loans had been repaid quickly, and were taken out for precautionary reasons rather than for pressing cashflow needs. That said, the impact of local lockdowns on the revenue of firms in sectors such as hospitality could prompt renewed demand for Government-backed loans. The latest data from HM Treasury (released on 22 October 2020) on gross lending showed a continued rise in the use of Government schemes – with £62b being lent to date.

Lending growth is expected to reverse some of the dramatic swings seen in 2020



Source: EY ITEM Club

Having borrowed so much during the crisis, as and when conditions allow, companies may want to focus on repairing their balance sheets rather than borrowing for growth, and Government-backed loans will have to be repaid. However, given the scale of growth in lending earlier this year, we expect the stock of business loans to rise by a 12-year high of 11% this year – compared to only 2% in 2019 and an average of − 1.4% from 2010 to 2019. Growth is then forecast to slow to 5.2% in 2021, before turning negative in 2022.

Banking sector summary

	2018	2019	2020	2021	2022	2023
Total assets (£b)	7,486	7,444	7,524	7,754	7,888	8,071
Total loans (£b)	6,102	5,945	6,178	6,394	6,507	6,643
Business/corporate loans (£b)	435	444	493	519	515	513
Write-offs (% of loans)	0.3	0.3	0.4	0.5	0.4	0.3
Consumer credit (£b)	219	224	212	213	226	241
Write-offs (% of loans)	1.2	1.5	1.3	2.5	2.0	1.4
Residential mortgage loans (£b)	1,407	1,452	1,498	1,549	1,580	1,615
Write-offs (% of loans)	0.01	0.01	0.02	0.05	0.04	0.02
Deposits (% year)	2.2	1.0	6.6	3.4	4.1	4.5
Loans/deposits (%)	133	128	125	125	122	119
Total operating income (£b)	127	124	117	125	132	137

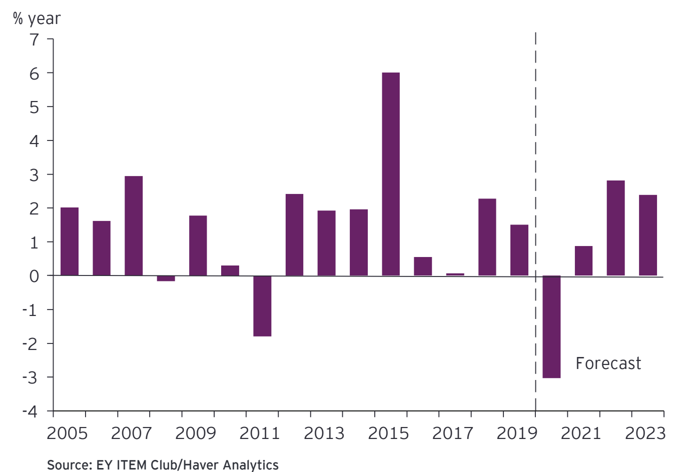
Source: Bank of England/Oxford Economics

Insurance

A weak outlook for jobs and incomes creates further challenges for insurers

The COVID-19 pandemic and measures to control the virus will weigh heavily for the insurance sector. The unemployment rate is forecast to peak at 7.5% early next year, almost double pre-pandemic levels. A 3% drop in real household incomes is also expected in 2020 — the biggest since records began in 1955 — with a 0.9% rise forecast in 2021, making up only some of the loss.

2020 is forecast to see a record drop in real household incomes



Source: EY ITEM Club/Haver Analytics

The pandemic impact will reduce non-life premium growth

The collapse in new car sales during the lockdown period will exert a toll on non-life premium growth in 2020. New car registrations in April were down 97.7% on a year earlier and the 4,321 new cars sold that month was at its lowest since 1946. For Q2, registrations dropped 70.1% year-on-year, but were up year-on-year over July and August following showroom re-openings in June. Yet the rebound was short lived, as registrations fell again in September following an initial surge from pent-up demand. The 1.7m new car registrations forecast by the EY ITEM Club for 2020 would be down from 2.3m in 2019, and at its lowest since 1982.

The market for new cars fell off a cliff during the lockdown
Millions, rolling 12-month total

Source: EY ITEM Club/Haver Analytics

Developments in the price of motor insurance present a further challenge for premium income growth. In the year to August 2020, the average price of motor insurance was flat on a year earlier — the first month for almost a year to see no rise in prices. In context, the cost of motor insurance had been rising in excess of 12% as recently as March.

Price movements have become even more unfavourable for home contents insurance. Prices for home policies fell 2.3% in the year to August — the fourth successive month of deflation. That said, the speed of the recovery in the housing market offers an upside for insurance demand. Housing transactions, an important driver of big-ticket and insurable household purchases, dropped by over 50% during Q2, but had made up three-quarters of the shortfall come August 2020. It remains to be seen if the fulfilment of pent-up demand and the prospect of increased unemployment may impact the housing market rebound, and lead some to defer purchasing or renewing insurance policies.

Overall, the EY ITEM Club's latest forecast shows non-life premium income falling by almost 2.5% across 2020 — the biggest drop since 2009 — before a return to growth of 2.9% in 2021.

Insurance price growth has fallen back
Annual % change in price

Source : EY ITEM Club/ONS

No end in sight for ultra-low interest rates

The BoE cut the UK official interest rate to a record low of 0.1% earlier this year, and we expect no move upwards until late-2022. Central banks around the world have also loosened monetary policy to an unprecedented degree, pushing bond yields down, and increasing the pressure on life insurers' returns. As such, the incentive to pursue alternative investments such as infrastructure and reduce reliance on the bond market will only rise. We see the 20-year gilt yield at only 0.7% this year, compared to an average of 1.7% in the five years to 2019.

In terms of life companies' equity holdings, global equity values appear expensive relative to economic fundamentals, particularly in the US, but are underpinned by record policy support. UK equities appear much cheaper than their developed market peers, but this partly reflects a structural decline in UK profitability, which is likely to have been worsened by COVID-19. The UK-EU trade uncertainty could also continue to weigh on the UK market in the near term.

However, demographic developments remain an upside, supporting flows of money leaving defined benefit schemes and moving into individual pensions and pensions drawdown products. The rise in the state pension age to 66 in October 2020 may also prolong pension contributions, while the UK population aged 65 or older is projected by the Office for National Statistics (ONS) to grow from 12.3m in 2019 to 13.7m by 2025, encouraging the retirement market. Meanwhile, pension opt out rates remain low — benefiting the insurance sector from pensions auto-enrolment. According to the ONS, in 2019, 77% of UK employees were members of a workplace pension scheme, up from 47% in 2012 when auto enrolment began, and the highest membership rate since comparable records began in 1997.

Data from the Pensions Regulator showed a total of £90.4b saved by eligible savers in 2018 — an increase of £16.8b from 2012.

Against a challenging backdrop, the EY ITEM Club predicts life premiums to fall by 4.8% across 2020, the first drop since 2016, with growth of 3.4% expected in 2021.

Profits will be weakened by COVID-19 related claims, low interest rates and regulation

COVID-19 related insurance pay-outs, including claims for event and travel cancellations, business interruption, and losses to investment portfolios present challenges for growth in the insurance sector. Moreover, the economic shock delivered by the pandemic means prolonged ultra-low interest rates, and The Financial Conduct Authority's (FCA's) general insurance pricing review will likely have an impact on profits in 2021.

A lower level of economic activity may reduce claims, particularly with many sporting, social and hospitality events being cancelled and, with more customers staying at home, accident claims have fallen. Longer-term, demographic developments continue to offer some upside. Although life expectancy for men and women in 2019 rose to 79.4 years and 83.1 years respectively, rises continued to be small in comparison with that seen during the 2000s. The impact of the COVID-19 pandemic on mortality and morbidity profiles will also affect the outlook for profits. In summary, while 2020 is predicted to challenge UK insurance profitability, the sector is expected to experience positive growth in 2021.

Insurance sector summary

	2018	2019	2020	2021	2022	2023
Life gross premium (£b)	176.3	177.4	168.8	174.5	187.5	198.6
% year	0.9	0.6	-4.8	3.4	7.4	5.9
Life gross claims payments (£b)	155.2	152.5	158.7	157.0	166.8	174.8
Life claims ratio (%)	88	86	94	90	89	88
Non-life gross premium (£b)	75.6	76.0	74.2	76.4	80.0	83.6
% year	3.0	0.5	-2.3	2.9	4.8	4.5
Non-life gross claims payments (£b)	30.9	35.0	39.6	40.2	41.5	42.6
Non-life claims ratio (%)	52	46	53	53	52	51
Net profit (£b)	6.8	9.5	5.5	6.3	6.9	8.1

Source: OECD, Swiss Re, Oxford Economics

Wealth and asset management

The economic shock of COVID-19 is set to decrease the value of UK asset managers AUM across 2020

Although equity prices have made up some of the large losses seen during the lockdown, the FTSE All-Share Index ended Q3 2020 almost 22% down on its level at the start of the year — the worst performance over an equivalent period since 2009, with other asset classes having also suffered from the economic shock. However, the effect of a weaker pound in pushing up the value of foreign currency denominated assets will go some way to mitigating the effect on the overall value of UK asset managers AUM. 2020 is forecast to see the value of AUM decline by 1.5% — a turnaround on growth of 11.6% in 2019.

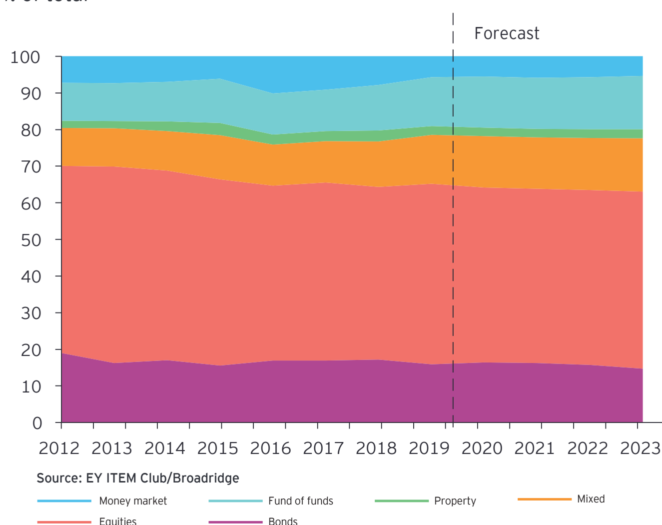
Assuming a return to more 'normal' economic conditions in 2021, markets, and the value of AUM, should see a rebound next year. Those households in aggregate that accumulated substantial extra savings during the lockdown period could aid in this if people remain more prudent in the face of uncertainty. EY ITEM Club expect the value of AUM to rise by 3.2% next year.

Equity prospects are unclear, but bonds will benefit from ultra-low rates and central bank purchases

In the face of heightened uncertainty and an adverse outlook for jobs and incomes, investors are likely to become more risk averse, leading to a falling share of equities in AUM. Admittedly, retail demand for certain individual stocks, mainly in the tech sector, has increased in recent months. But this has contributed to global equity values appearing expensive relative to economic fundamentals — particularly in the US — albeit underpinned by record policy support. UK equities appear much cheaper than their developed market peers, but this partly reflects a structural decline in UK profitability, which is likely to have been exacerbated by the pandemic. A lack of clarity over whether the UK and EU will arrive at a trade deal will also weigh on the UK market in the near term, although the weak pound and the discount that UK equities are now trading on, relative to other markets, could work in the opposite direction. Finally, the decision by many listed companies to suspend dividends as a result of the COVID-19 crisis has reduced the attractiveness of investment funds seeking income.

Risk aversion also bodes negatively for alternative, riskier, asset categories like property — although the possibility of a faster-than-expected recovery and return to normality in the event of medical advances or a COVID-19 vaccine could see investor sentiment turn around rapidly. The disappointing performance of many UK hedge funds during the pandemic is likely to weigh on inflows into this category.

Equities are forecast to become a little less dominant in AUM
% of total



Source: EY ITEM Club/Broadridge

Bonds are likely to see their share in UK AUM rise as a result of the crisis. Although yields in the UK, and many other economies, are hovering around record lows – the chance that central banks could loosen policy further via negative, or in the European Central Bank's (ECB's) case, even more negative interest rates and asset purchases will favour fixed-income assets. As well as Government bonds, alternative funds such as infrastructure, which offer a relatively stable and resilient source of income in a world where dividends have been cut or suspended, could prove attractive to investors in a period of instability.

Meanwhile, the pandemic's effect on energy demand and the social dimension of the pandemic's impact and appetite for a 'green recovery' may accelerate the rise of Environmental, Social and Governance (ESG) investing.

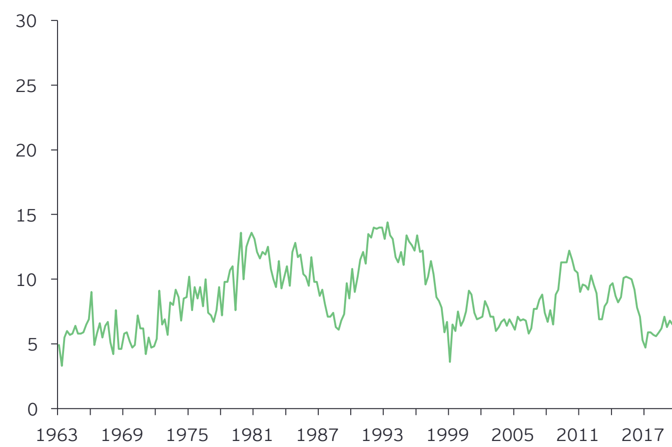
The prospect of persistently higher saving offers a potential source of inflows into AUM

Households' normal spending habits were reduced during the lockdown. Combined with support to incomes from Government measures, including the Furlough Scheme, increases to welfare benefits, and tax deferrals, the household saving ratio soared to 29.1% in Q2 – more than double the previous record of 14.4% in 1993. Greater saving contributed to household bank deposits rising 7.4% year-on-year in the same period, the biggest increase in 12 years.

Despite falls in equity prices, household gross financial assets, as a share of incomes rose, to 490% in the year to Q2 – the second highest ratio since records began in 1987.

Households saved a record amount in Q2 2020

% of total household resources



Source: EY ITEM Club/Haver Analytics

Although the EY ITEM Club expects savings to fall back as the economy reopens and consumer confidence revives, the fact that many consumers have experienced two major economic shocks in 12 years may well encourage a greater degree of prudence. Our forecast sees the household saving ratio averaging 9.9% over 2021 to 2023 – up from an average of 6.2% from 2017-2019.

Wealth and asset management sector summary

	2018	2019	2020	2021	2022	2023
Total assets under management (£b)*	1,321	1,474	1,452	1,499	1,568	1,670
% year	-6.3	11.6	-1.5	3.2	4.6	6.5
Bonds (£b)	228	235	239	244	246	245
Equity (£b)	622	727	693	713	750	808
Fund of funds (£b)	164	197	203	210	222	243
Hedge (£b)	1.5	1.6	1.2	1.3	1.3	1.4
Mixed (£b)	165	170	163	173	184	202
Money market (£b)	102	109	119	123	127	129
Property (£b)	39	35	34	35	38	41

*Funds where at least 60% of assets are held by UK-domiciled investors
Source: Oxford Economics; Broadridge

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