Eurozone

Ernst & Young Eurozone Forecast

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Outlook for financial services

Ernst & Young

Quality In Everything We Do

Welcome

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With an increasing regulatory burden raising costs and complexity on the one hand and a deepening recession limiting revenue opportunities on the other, 2013 is likely to be another challenging year for the Eurozone's financial services industry.

But plans to hand over supervision of the Eurozone's largest banks to the European Central Bank (ECB) are a vital and concrete step towards full banking union and addressing the region's structural problems. By reducing systemic risk, the single supervisory mechanism should further improve confidence in the Eurozone's financial sector — helping to unlock credit markets and improve the flow of capital so vital to the Eurozone's longer-term economic growth prospects.

The news comes at a time when demand within the Eurozone has fallen. The regulatory backdrop has played a key part in this downturn, as banks have shrunk loan books and raised capital to meet the standards for Basel III. As we now expect Eurozone GDP to contract by 0.2% in 2013, policy-makers will need to focus significantly more on growth rather than austerity measures to avoid the risk of a Japan-style "lost decade" of negligible economic growth.

For the region's corporates we see a divergent operating environment between those focused on a moribund domestic market and those exposed to faster external growth rates with the balance sheet to exploit them. Shrinking domestic demand will inevitably hit overall corporate profitability and drive further rises in Eurozone banks' bad debts. Non-performing loans are expected to hit 6.8% for 2012 as a whole, peaking at a euro-era record of 7.6% of total gross loans in 2013. Unsurprisingly, rising bad debts are driving ever-tighter lending standards. This puts further downward pressure on loan books already shrinking to meet capital ratio requirements.

For Eurozone banks the overwhelming challenge continues to be one of improving returns and reshaping their businesses under the Basel III framework. We expect further changes to banks' capital mix in 2013, including a marked improvement in loan-to-deposit ratios.

But while bond issuance will continue to outpace loan growth in 2013, the headline figures disguise a sharply contrasting two-tier market in which small and medium-sized enterprises (SMEs) struggle to access finance. Bond investors may be picking up the slack created by shrinking bank loan books for larger multinationals, but they have significantly less interest in providing finance to smaller companies.

However, there are signs of progress on this front. Policy-makers have acknowledged that loan growth to SMEs within the Eurozone stems as much from smaller banks as it does from the larger global banks. As argued by some commentators, these larger banks benefit from implicit government backing, which results in easier and cheaper access to credit. Addressing this anomaly and easing credit conditions for smaller and regional banks could help to improve the flow of capital to the wider economy significantly.

For the Eurozone's insurers, the main focus in the coming months will also be on optimizing the business mix in a changing regulatory environment. Cost savings and improving efficiency remain a fundamental part of this ongoing process. Already delayed, the failure to agree key aspects of Solvency II is making long-term decisions difficult at a time when the backdrop to new business and profitability remains constrained. Recession and austerity measures are slowing down demand and increasing price pressure across all lines of business. In particular, the reduction in major consumer trigger-events, such as house and car purchases, continues to weigh on new business levels.

In contrast, the immediate outlook for the region's asset managers looks brighter. The sector should prove to be one of the few beneficiaries of consumer caution due to higher savings and investment rates. We see another year of positive growth for assets under management (AUMs) in 2013, with total assets expected to rise 6.5% after a 9.6% jump in 2012. The growth is likely to be driven by solid market returns and a gradual shift from low-yielding savings accounts into higher-yielding bond and cautiously managed mixed asset funds.

We hope you find the following forecasts for the financial services sector informative and thought provoking. Keep up-to-date with Eurozone developments: visit our website www.ey.com/eurozone or follow us on Twitter: @EY_Eurozone.

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Executive summary

Overview

Businesses need to plan for the risk of a "lost decade" in Europe. Growth in the Eurozone will be held back for an extended period and unemployment will continue to rise this year — peaking at close to 20 million. As the Eurozone undergoes painful but necessary restructuring, we expect two years of recession — 2012 and 2013 will see GDP contracting by 0.4% and 0.2% — before growth returns from 2014 onwards (Table 1). Even then progress will be slow, with average expansion of just 1.3% a year for the rest of the decade.

However, the future of the Eurozone now looks more secure. ECB action has eased the threat of an imminent breakup. A banking union looks more likely and the policy mix is at last shifting from austerity to growth. A deal reached in November 2012 has sustained Greece's position for now, allowing the next tranche of bailout funding to be released.

But more progress is needed. Despite an agreement to establish a common Eurozone banking supervisor in mid-December 2012, the framework for a full banking union remains incomplete. To complete the framework, a single resolution mechanism and a Eurozone-wide deposit guarantee scheme also need to be put in place. In addition, more detailed plans and a precise timetable for closer fiscal union need to be established. Euro-bonds are still a distant prospect, and we have yet to see how the Growth Pact will be implemented. Until these issues are resolved, business confidence will remain changeable.

In the meantime, some peripheral economies have made considerable progress; for instance, productivity has improved in Ireland and Spain. This has helped boost competitiveness and is reflected in strong export growth. However, this progress comes mainly as as result of employing fewer workers which also has negative consequences. In the short term, household incomes will be squeezed, deepening and prolonging the domestic recessions in these countries.

One welcome shift in policy is the revival of the Growth Pact. This envisages supply-side reforms that should have longer-term benefits, and it extends policy beyond the current emphasis on austerity. The idea that deficit-cutting can boost growth has been largely contradicted by recent evidence. Even the International Monetary Fund (IMF), a long-time advocator of fiscal reform to drive growth, now recommends a more balanced approach. Without abandoning its general principle of reducing public deficits, the IMF suggests a slower pace and stresses the need for broader economic reforms. Continued uncertainty about the future budget of the EU means that the measures contained in the Growth Pact are unlikely to alter prospects for demand and growth in the short term.

The most effective boost to growth would come from an end to uncertainty about the future of the euro. This would unlock investment and recruitment plans currently placed on hold by companies that are waiting to see what happens.

Table 1 — Forecast for the Eurozone economy (annual percentage changes unless specified)

	2011	2012	2013	2014	2015	2016
GDP	1.5	-0.4	-0.2	1.0	1.4	1.5
Consumer prices	2.7	2.5	1.9	1.5	1.3	1.3
Unemployment rate (level)	10.2	11.4	12.3	12.3	12.0	11.7
Government budget (% of GDP)	-4.1	-3.3	-2.6	-2.1	-1.7	-1.3
Government debt (% of GDP)	87.6	91.6	94.5	96.1	97.0	97.4
ECB main refinancing rate (%)	1.2	0.9	0.8	0.8	0.8	0.8
Exchange rate ($ per €)	1.39	1.28	1.27	1.21	1.17	1.17

Source: Oxford Economics

Sector highlights

Banking

- **We believe that deleveraging by banks in the Eurozone is around two-thirds complete.** Banks pose less of a systemic threat to the economy, but they are not healthy enough to drive growth. To help ensure the longer-term health of the Eurozone banking system, the framework for a full banking union needs to be completed.
- **Average loan-to-deposit ratios have fallen, but still have some way to go.** Before the crisis, ratios were as high as 124% in 2006. They have now come down to 111%, but are likely to fall to 106% by the end of 2013 and 104% in 2016. Although this will reduce vulnerability to wholesale funding drying up, loan-to-deposit ratios would still be significantly higher than the current average ratio of 70% for commercial banks in the United States.
- **We expect a rise in non-performing loans.** Credit quality in the euro region has deteriorated more sharply than expected, pushing non-performing loans to a euro-era high of 7.6% of outstanding loans next year. But they should fall back to 5.6% in 2014 as economic conditions in the region improve.
- **Banks will be reluctant to lend and demand for credit is expected to remain subdued this year.** The weak economy and uncertain policy environment continue to dampen confidence. Following an estimated 1.3% contraction of loans to non-financial businesses and households in 2012, we expect lending to the private sector to fall by a further 0.2% in 2013. Positive growth of 2.9% is then expected in 2014.
- **Credit contraction will be particularly severe in the peripheral economies, where fiscal austerity is dampening loan demand and credit conditions are tightest.** Lending in Spain is forecast to decline by 4.4% in 2013; by comparison, private sector loans in Germany will grow by 1.8%.

Insurance

- **We think that 2013 will see the bottom of the profit cycle in insurance, although subsequent recovery will be slow.** Even by 2016, we expect profits to be less than half the 2007 peak. Consolidation will therefore continue, as will the implementation of controls to improve profit margins. The industry has suffered from a prolonged period of low interest rates, poor business conditions and extraordinarily costly natural disasters. Profits fell by 7% in 2011, and we expect a further decline of 5% overall in 2012, before starting to recover this year.
- **Life insurers are being hit particularly hard by the headwinds battering the Eurozone insurance industry.** With the working-age population slowly declining and nominal personal income growth expected to be just 1.5% in 2013, life premiums will increase by just 0.5% in 2013, following a cumulative fall of 8% in 2011 and 2012. The Italian life market has been particularly badly affected, with a 25% fall in premiums over the last two years. We expect a further fall of 4% in 2013 as Italian households continue to see their real incomes eroded. Premiums should eventually pick up as incomes begin to rise again, but even by 2016 they are likely to be 25% lower than 2008 levels.

Sector highlights

- **Non-life premiums are likely to rise just 1.8% this year and 1.9% in 2014, as the Eurozone economy is expected to contract for the second consecutive year in 2013.** This is substantially below the historic average of 6.2%, reflecting an environment in which insurers find it difficult to maintain price increases. Motor insurance will suffer especially, with car registrations declining by almost 5% in 2013 and then growing by just 0.9% in 2014.

Asset management

- **We have raised our forecast for growth in Eurozone-wide AUMs in 2012 from 8.8% to 9.6%.** This incorporates a slightly stronger end to the year than we expected for risk assets. Bond and equity funds have benefitted from an increase in investor optimism about the Eurozone's chances of surviving intact.
- **AUM growth is expected to slow in the coming years.** Initially the slowdown will be limited as further progress towards securing the Eurozone's future should continue to attract money into Eurozone assets in the short term, enabling AUMs to grow by 6.5% in 2013. However, in the longer term, deleveraging and slow economic growth, combined with low investment returns, will hold AUM expansion to just 4% on average between 2014 and 2016. The strongest equity AUM growth is expected to be in the periphery, because these markets attract value investors who believe the euro will survive. However, investors will need stable funding and strong conviction to hold their positions through the volatility that will inevitably occur from episodes of heightened market concerns about a Eurozone breakup. This will increasingly force investors to explore rapid-growth markets, alternative asset classes such as property and infrastructure, and non-correlated strategies for higher returns.
- **Yields are expected to rise in the "safe-haven" bond markets of Germany and France, as fears of a Eurozone breakup gradually dissipate.** As yields rise, total bond returns and AUMs are expected to fall in the core markets. By contrast, bond AUMs are expected to rise in Italy and Spain as spreads narrow and investors return to the Italian and Spanish markets following the ECB's commitment to cap yields.

Banking

We believe that deleveraging by banks in the Eurozone is around two-thirds complete. Banks pose less of a systemic threat to the economy, but they are not healthy enough to help the Eurozone economy avoid a "lost decade". To help ensure the longer-term health of the Eurozone banking system the framework for a full banking union needs to be completed. Although an agreement was reached in December 2012 to set up a common banking supervisor, a single resolution mechanism and a deposit guarantee scheme still need to be put in place. Failure to complete the banking union framework in a timely manner is likely to negatively impact confidence.

Average loan-to-deposit ratios have fallen from a pre-crisis peak of 124% in 2006 to an estimated 111% at the end of 2012. But we believe that this process still has further to go, with average loan-to-deposit ratios likely to fall to 104% in 2016 (Table 2). This will help make banks less vulnerable to wholesale funding drying up. Pressure to consolidate or start joint ventures will be high in this capital intensive environment, with competition for deposits likely to squeeze profit margins.

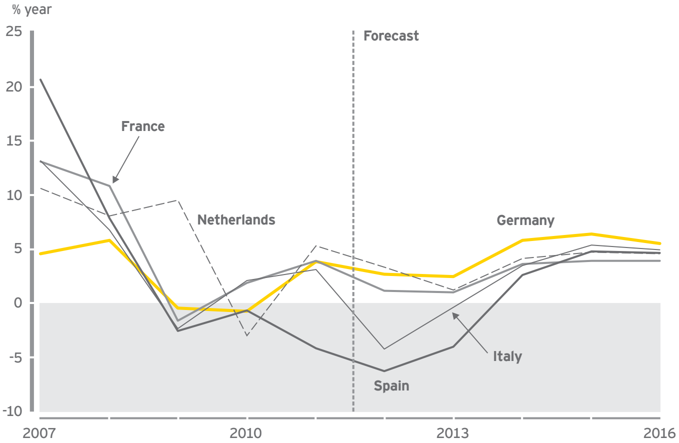
We expect the proportion of Eurozone bank loans that are non-performing to climb to a euro-era high of 7.6% by the end of 2013, from 6.8% in 2012 (Chart 1 and Table 2). Fears of a further deterioration in credit quality mean that funding markets have remained closed to smaller banks or those facing potentially significant losses on their loan books. This is despite the ECB's announcement of a new bond-purchase program that has precipitated a significant improvement in the cost and availability of market funding for some large Eurozone banks.

The latest ECB Bank Lending Survey showed banks once again tightened their lending criteria slightly, this time due to rising concerns about the economic outlook rather than a lack of access to funding.

The deterioration in credit conditions has been particularly acute for non-financial corporate (NFC) lending, where the rate of contraction accelerated to 1.4% in the year to September 2012. Following an estimated 2.1% contraction of loans to non-financial companies (NFC) in 2012 as a whole, we have downgraded our forecast for loan growth in 2013 to just 0.2% from 1.1% previously (Chart 2 and Table 2).

Chart 2

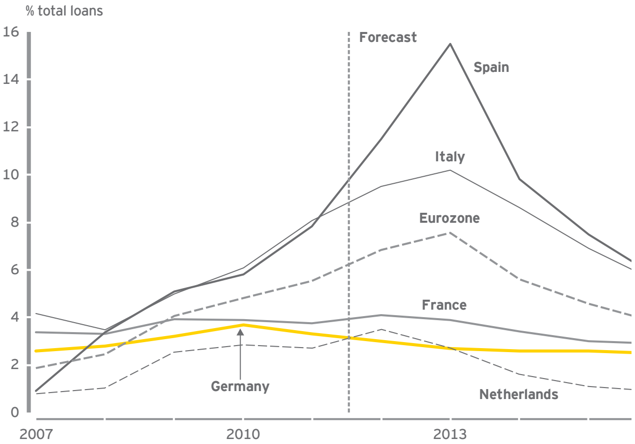
Lending to non-financial corporations



Source: Oxford Economics, Haver Analytics

Chart 1

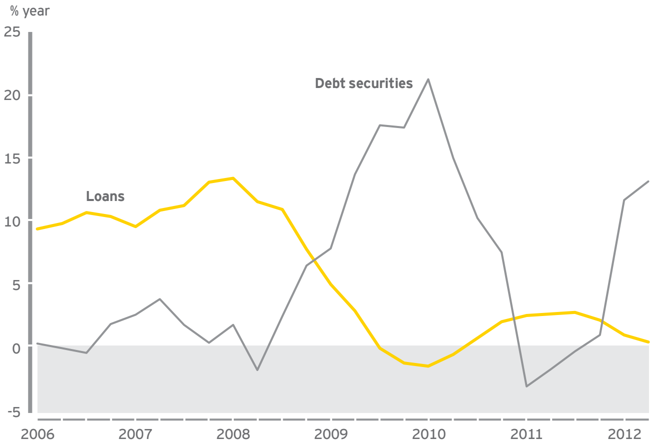
Eurozone Non-performing bank loans



Source: Oxford Economics, World Bank

Chart 3

Funding mix of non-financial corporates



Source: ECB

Banking

Lending to NFCs is not forecast to approach its pre-crisis peak until 2014. With uncertainty about the economic outlook continuing to dampen business confidence, tight credit conditions will act as an additional constraint on investment expenditure.

Until the Eurozone's fragmented banking system is repaired it will continue to act as a drag on activity in the periphery economies. Until policymakers take the bold decisions needed to ensure the single currency's longer term survival, confidence will remain subdued and banks will prefer to conserve funds rather than direct them towards new lending.

The downturn in bank lending is driving more financial market activity towards non-bank lenders, such as credit focused hedge funds. The extent of the disintermediation of bank credit is illustrated by Chart 3, which shows how debt issuance by NFCs has risen sharply at the same time as lending has stagnated. This disintermediation of bank credit is likely to add to pressures for a reassessment of the regulations governing non-bank financials.

Support for a harmonized financial transactions tax (FTT) in the Eurozone appears to be growing, with 11 member states having indicated their willingness to participate. Although precise details have not been finalized, it is likely that banks' trades in derivatives and equities will be captured. This will create a difficult landscape for investment banks. They will need to decide how to comply with both regulations around central clearing and the FTT for their derivatives trading activities. Moreover, it is likely that higher borrowing and hedging costs for banks will be passed to the non-financial sector and then onto consumers, as a result of lower returns on pension assets and higher energy and commodity costs.

We expect bank operating income to grow by just 3% in 2013. Deleveraging and higher bad debts are expected to continue to undermine retail bank earnings for some time. Although investment banks benefited from the resurgence of debt issuance in 2012, regulatory pressures and a weak economic backdrop will continue to dampen profits, forcing a fundamental restructuring of their cost base and business models.

Table 2 — Eurozone — Banking

	2011	2012	2013	2014	2015	2016
Total assets (€b)	33,538	33,631	33,200	33,928	34,790	35,736
Total loans (€b)	12,321	12,264	12,132	12,487	12,957	13,462
Business/corporate loans (€b)	4,719	4,619	4,628	4,821	5,074	5,321
Consumer credit (€b)	628	604	597	606	622	639
Residential mortgage loans (€b)	3,784	3,791	3,767	3,827	3,917	4,018
Non-performing loans as % of total gross loans	5.6	6.8	7.6	5.6	4.6	3.8
Deposits (% year)	1.9	0.9	3.2	4.1	4.3	4.3
Loans/deposits (%)	113	111	106	105	105	104
Total operating income (€b)	630	632	651	706	769	840

Source: ECB, Oxford Economics

Table 3 — Forecast for the Eurozone economy

	2011	2012	2013	2014	2015	2016
Macro variables						
Nominal GDP growth (%)	2.7	0.9	1.1	2.4	2.8	2.9
Real GDP growth (%)	1.5	-0.4	-0.2	1.0	1.4	1.5
Nominal consumption growth (%)	2.6	1.1	1.6	2.1	2.4	2.6
Nominal personal disposible income growth (%)	2.0	0.7	1.5	2.2	2.3	2.4
Nominal private investment growth (%)	3.6	-2.4	-0.5	3.5	4.3	4.2
Financial variables						
EURIBOR — 3 months (%)	1.4	0.6	0.3	0.3	0.4	0.5
10-year government bond yield (%, Eurozone average)	4.4	4.0	3.5	3.6	3.8	4.1

Source: Oxford Economics

Insurance

Insurers' profits are expected to start rising again in 2013, however, by 2016 they are still forecast to remain below the 52% peak reached in 2007 (Chart 4). We expect the 7% fall in profits recorded in 2011 to be followed by a further decline of 5% in 2012, due to poor business growth and subdued investment returns (Table 4). Profit recovery is expected to be slow due to a prolonged period of low interest rates. In addition, the operating environment will remain tough for the Eurozone insurance industry for the foreseeable future. The industry continues to suffer from excess capacity which is weighing on prices and, hence, profits. Consequently, the industry will continue to focus on consolidation and implement controls aimed at improving profit margins.

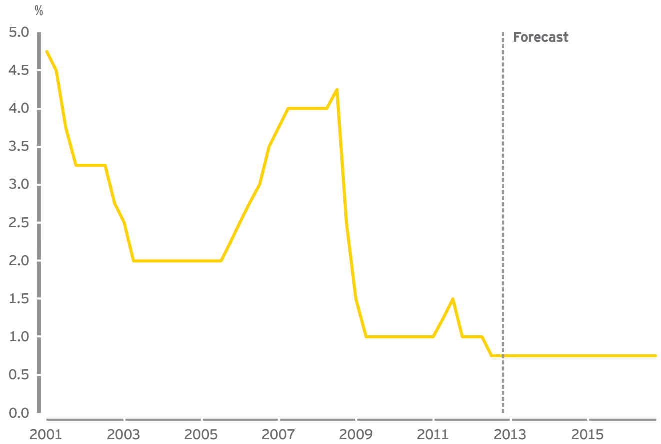
Life insurers will continue to face significant headwinds for the foreseeable future. At the end of 2016, premiums are still expected to be 25% below the 2008 peak. We expect the Eurozone to experience a "lost decade" of low growth as deleveraging continues. Against that backdrop, the ECB is likely to keep interest rates pegged at just 0.75% until mid-2017, weighing on insurers' investment returns (Chart 5).

We forecast the unemployment rate will rise further, from 11.5% in Q3 2012 to a peak of 12.4% in early 2014. With the working age population slowly declining and nominal personal income growth expected to be just 1.5% in 2013 (Table 5), life premiums are expected to grow by just 0.5% in 2013, following a cumulative fall of 8% in 2011 and 2012 (Table 4). After that, as income growth improves, so will premium growth. The Italian life market has been hit particularly hard, with a 25% fall in premiums over the past two years. We expect a further fall of 4% in 2013, as Italian households continue to see their real incomes eroded (Chart 6).

The Eurozone economy is expected to contract for a second year running in 2013, with GDP falling by 0.2% before growing by just 1.0% in 2014 (Table 5). Non-life premium growth is expected to be just 1.8% this year and 1.9% in 2014. This is substantially below its historic average of 6.2%, as business weakens and insurers find it difficult to maintain price increases (Table 4). For example, motor insurers will face a tough environment given that car registrations are forecast to decline by an additional 4.8% this year and then grow by just 1.0% in 2014 (Table 5).

Chart 5

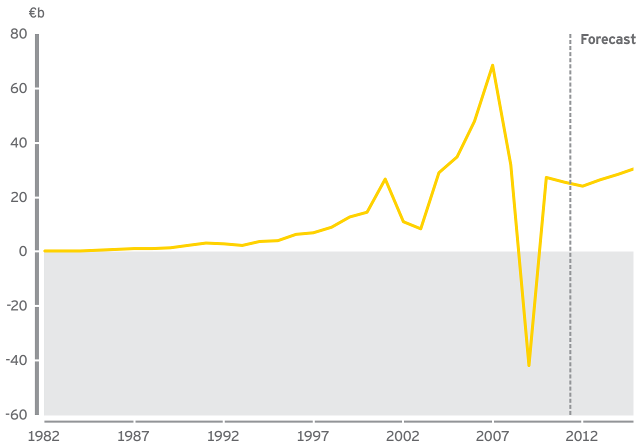
ECB refi rate



Source: Oxford Economics, Haver Analytics

Chart 4

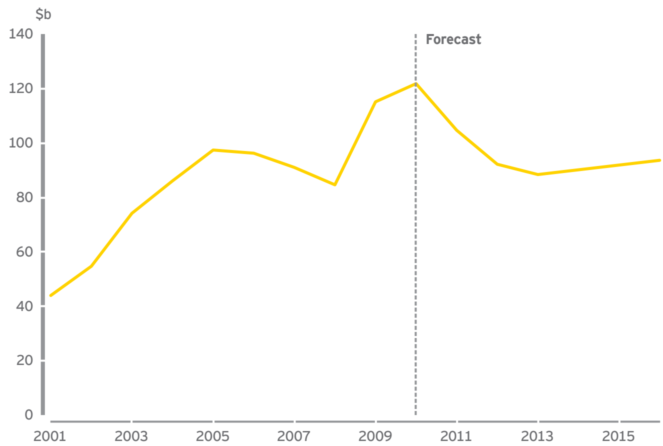
Eurozone insurance industry profits



Source: Oxford Economics, Datastream

Chart 6

Italian life premiums



Source: Oxford Economics

Insurance

Table 4 — Eurozone — Insurance

	2011	2012	2013	2014	2015	2016
Life gross premium ($b)	447	431	433	444	454	465
% year	*-4.0*	*-3.6*	*0.5*	*2.4*	*2.4*	*2.4*
Life gross claims payments ($b)	239	241	259	266	276	288
Life claims ratio (%)	*53*	*56*	*60*	*60*	*61*	*62*
Non-life gross premium ($b)	403	404	411	419	430	441
% year	*7.9*	*0.3*	*1.8*	*1.9*	*2.6*	*2.7*
Non-life gross claims payments ($b)	268	264	263	269	277	289
Non-life claims ratio (%)	*66*	*65*	*64*	*64*	*64*	*66*
Profits (€b)	25.4	24.1	26.4	28.6	30.7	32.9

Source: Oxford Economics

Table 5 — Forecast for the Eurozone economy

	2011	2012	2013	2014	2015	2016
Macro variables						
Nominal GDP growth (%)	2.7	0.9	1.1	2.4	2.8	2.9
Real GDP growth (%)	1.5	-0.4	-0.2	1.0	1.4	1.5
CPI (% yoy)	2.7	2.5	1.9	1.5	1.3	1.3
Labour market						
Total employment (thousands)	147,051	146,080	144,898	144,759	145,098	145,448
Employment in manufacturing (thousands)	22,848	22,290	22,008	22,071	22,194	22,147
Employment in non-manufacturing (thousands)	124,203	123,789	122,890	122,688	122,904	123,301
Unemployment (thousands)	16,033	18,166	19,655	19,636	19,116	18,638
Demographics						
Population (thousands)	332,370	333,025	333,611	334,164	334,678	335,148
Population of working age (thousands)	219,535	219,035	218,453	217,878	217,313	216,786
Population, 65+ (thousands)	61,623	62,742	63,885	65,021	66,171	67,259
Consumers						
Nominal personal disposable income (% yoy)	2.0	0.7	1.5	2.2	2.3	2.4
Gross household financial wealth (€b)	15,784	16,708	17,210	18,095	18,993	19,941
Total household borrowings (€b)	6,702	6,679	6,673	6,737	6,868	7,041
Motoring						
Car registrations (thousands)*	7,901	7,116	6,773	6,837	6,923	7,014
Housing market						
House prices (% yoy)	1.0	-1.0	-0.6	1.7	2.4	2.6
Corporate sector						
Company profits (€b)	2,096	2,064	2,040	2,079	2,134	2,199
Financial variables						
3-month Euribor rate (%)	1.4	0.6	0.3	0.3	0.4	0.5
10-year government bond yields (%)	4.4	4.0	3.5	3.6	3.8	4.1
Equity market (% yoy)	-17.1	8.7	5.4	9.8	9.0	8.4

Source: Oxford Economics

*Car registrations and company profits refer to the sum of Germany, France, Italy and Spain

Asset management

We forecast that Eurozone-wide AUMs will have grown by 9.6% in 2012, enabling assets to hit a new high of €4.4t. This is 0.8% higher than we forecast in the Autumn 2012 *Outlook for financial services*, and is due to a better than expected end of the year for risk assets. The main drivers of the rise in AUMs are expected to have been the bond and, to a lesser extent, the equity asset classes. Since summer 2012, both asset classes have benefitted from rising investor optimism about the Eurozone's chances of surviving intact. This will have helped to boost both fund values and inflows. In response to the establishment of Mario Monti's pro-reform government, Italian bond funds are expected to have experienced a 17% rise in AUMs during 2012 to €150b. Given that this surge in Italian bond AUMs was a one off valuation driven adjustment, we do not expect it to be repeated in 2013.

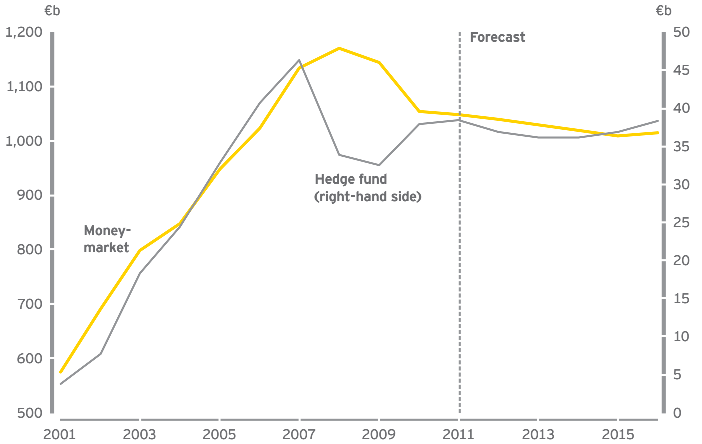
AUM growth is expected to slow in the coming years. Initially, the slowdown will be a little less pronounced than we were forecasting at the time of the Autumn 2012 *Outlook for financial services*, as further progress toward securing the currency's future continues to attract money into Eurozone assets in the short-term. This is expected to enable AUMs to grow by 6.5% in 2013 rather than the 5.8% predicted in our Autumn 2012 outlook (Table 7). However, AUM growth in the years from 2014 to 2016 is expected to slow to 4% — below the historic average of 6% — as deleveraging results in a "lost decade" of low Eurozone GDP growth and investment returns.

The strongest equity AUM growth is expected to be in peripheral rather than core equity markets, as these markets attract investors who believe the euro will survive intact. For example, we expect Italian and Spanish equity AUMs to rise by an average of 9.8% and 8.8% respectively between 2014 and 2016. This will outpace average German equity AUM growth of 7.0% over the same period. Investors will need to be able to hold their "pro-euro" positions through bouts of high volatility, however, resulting from periodic episodes of heightened market concerns about a Eurozone break-up.

With a "lost decade" of low growth in prospect, businesses face a tough operating environment. Companies will be more likely to outperform the wider equity market if they drive growth by improving competitiveness, win market share and export to more rapidly-growing economies, rather than assuming that growth will be driven by their domestic markets.

Chart 8

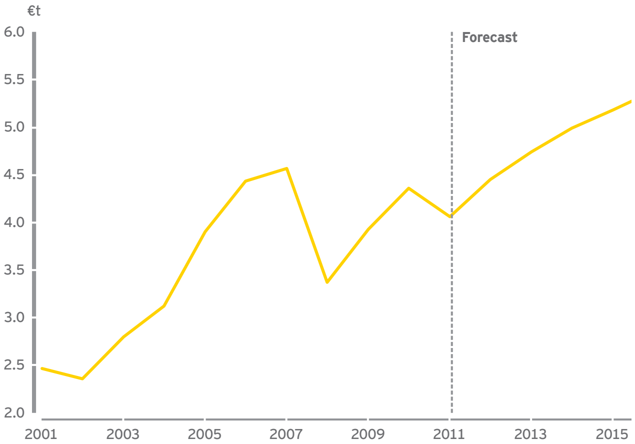
Money-market and Hedge fund AUMs



Source: Oxford Economics/LIPPER

Chart 7

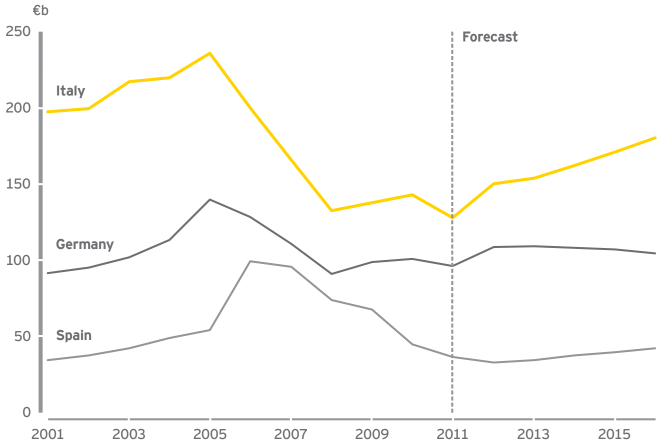
Total assets under management



Source: Oxford Economics/LIPPER

Chart 9

Bond fund AUMs



Source: Oxford Economics/LIPPER

Asset management

While we expect the Eurozone economy to contract by 0.2% in 2013 and then grow by just 1.0% in 2014 (Table 7), we anticipate that emerging markets will record growth of 5.7% in 2013 and 6.7% in 2014. Consequently, the equity market is likely to reward companies that are focused on exporting to these fast-growing economies.

Investors need to keep in mind that bond AUMs are expected to decline in the core countries of Germany and France as fears of a Eurozone break-up gradually recede. As a result, we expect yields to rise and total returns to fall. For example, we expect 10-year German bond yields to rise from their Q3 2012 average of 1.4% to 2.9% in Q4 2016. By contrast, bond AUMs are expected to rise in Italy and Spain as spreads narrow and investors return to the Italian and Spanish markets now that the ECB has made a strong commitment to cap yields in those markets (Chart 9). Between 2012 and 2016, we expect Spanish and Italian bond AUMs to rise by 28% and 20% respectively.

Trends in property AUMs are likely to diverge over the coming years. Although property AUMs have fallen for three years in a row in Germany, we expect them to rise by an average of 4% between 2013 and 2016, as investors are attracted by rising property prices. By contrast, we expect Spanish property AUMs to have fallen by 4% in 2012, as the decline in property prices continues until late 2014.

On average, pension funds have just 3.3% of their total assets invested in infrastructure. Over time, we expect this to rise to at least 5%. Infrastructure can provide investors with predictable, long-term returns and increased portfolio diversification. It also acts as a hedge against inflation. As a result, infrastructure investments are attracting more institutional investors who look to match long-term liabilities, such as the pension funds. Public sector pension funds, private sector pension funds and superannuation schemes make up 40% of the active global infrastructure investor universe. Europe is one of the main hubs of infrastructure investment activity, with 39% of all active pension plans in the infrastructure space based in Europe. Despite the high proportion of active pension plans based in Europe, the majority of these institutions currently invest only a small proportion of their total assets in infrastructure opportunities.

In 2011, there were 3.2 million European high-net-worth (HNW) individuals,* with an estimated total of $10.1 trillion of investible assets between them. However, a number of firm-specific and industry-wide trends are converging to undermine the profitability of European wealth management firms. These trends are exerting stress on wealth management business models. For instance, firms are faced with market volatility and wary investors, so need to create products that appropriately cater to client needs and risk profiles, while generating margins. In addition, given increasingly competitive conditions, firms have to decide when and how to pursue selective growth strategies or prepare for consolidation. At the same time, increased regulation is raising new hurdles to profitable entry and expansion in some markets, especially for smaller players.

The market is coming to terms with a shift to a fee based numeration model and faces uncertainty as to its effect in the coming year.

However wealth managers who do not already charge fees may find that clients resist paying up-front fees for a traditional advice service focused on supplying low-complexity products. This group of clients, will become more price-sensitive, putting downward pressure on wealth managers margins. This is likely to force private banks and wealth managers to either move up the wealth value-chain, quit the market or seek a managed exit, via sale or merger.

Client demand is likely to form two extremes. At the lower end of the wealth scale, clients who see no value in paying high advice fees will be served with 'straight-through' self-select products. With limited features and little to no human touchpoints. These products will be suitable for rapid turnover by advisers on low fee/high throughput models. By contrast, clients at the higher end will be willing to pay for a more comprehensive advice service, giving them access to more bespoke and complex products and services for fine-tuning their financial strategies.

* Those with over $1 million of investible funds

Table 6 — Eurozone — Asset management

	2011	2012	2013	2014	2015	2016
Total assets under management (€b)*	4,061	4,449	4,740	4,995	5,181	5,387
% year	*-6.9*	*9.6*	*6.5*	*5.4*	*3.7*	*4.0*
Bonds (€b)	1,024	1,261	1,453	1,558	1,577	1,598
Equity (€b)	1,187	1,313	1,392	1,520	1,664	1,807
Fund of funds (€b)	317	325	332	338	345	352
Hedge (€b)	38	37	36	36	37	38
Mixed (€b)	346	373	399	425	449	472
Money market (€b)	1,048	1,039	1,029	1,019	1,009	1,015
Property (€b)	101	100	98	99	101	105

Source: Oxford Economics, Lipper FMI

*UCITS and non-UCITS assets

Table 7 — Forecast for the Eurozone economy

	2011	2012	2013	2014	2015	2016
Macro variables						
Nominal GDP growth (%)	2.7	0.9	1.1	2.4	2.8	2.9
Real GDP growth (%)	1.5	-0.4	-0.2	1.0	1.4	1.5
CPI (%)	2.7	2.5	1.9	1.5	1.3	1.3
Financial variables						
EURIBOR — 3 months (%)	1.4	0.6	0.3	0.3	0.4	0.5
10-year government bond yield (%, Eurozone average)	4.4	4.0	3.5	3.6	3.8	4.1
DJ Euro Stoxx 50 Equity Price Index	2,317	2,518	2,654	2,915	3,176	3,443
Households						
Wealth (€b)	15,784	16,708	17,210	18,095	18,993	19,941
Savings flow (€b)	829	812	820	842	859	869
Pensions holdings (€b)	6,087	5,858	6,331	6,691	6,940	7,286

Source: Oxford Economics

Country forecast tables

France

Key issues and highlights

- **Demand for loans is likely to remain subdued given the sluggish outlook for economic activity, despite some of the larger French banks having benefited from improved access to market funding in recent months.** Our expectation is for the French economy to grow by just 0.2% in 2013 after expanding by an estimated 0.1% in 2012. Against this background, we forecast lending to the non-financial private sector to expand by just 0.5% in 2013.
- **French life premiums are expected to fall by a further 11.0% in 2012 and then by 3.5% in 2013** as weak household income growth continues to hit business (Table 9). Life premiums should start to recover in 2014, growing by just over 4%, but business will still be substantially below its previous peak in 2016.
- **It is unlikely that the 9.2% rise in 2011 non-life premiums will have been repeated in 2012, given the weakness of the domestic economy.** We expect growth of 1.1% in 2012 and a contraction of 0.1% this year (Table 9).
- **French AUMs are forecast to have risen by 4.6% in 2012 as both bond funds and money-market funds experienced AUM growth.** This will partially reverse last year's 13% decline in fund AUMs. The French asset management industry is dominated by money-market funds, accounting for almost half of AUMs. A 7.1% rise in money-market assets in 2012 was, in part, a reversal of a cumulative 24% fall in assets between 2009 and 2011. We expect money-market asset growth to slow in the years ahead as financial markets stabilize and investors are drawn to the higher yields offered by bonds and equities.

Table 8 — Banking

	2011	2012	2013	2014	2015	2016
Total assets (€b)	8,399	8,450	8,465	8,699	8,946	9,213
Total loans (€b)	2,248	2,259	2,263	2,339	2,420	2,507
Business/corporate loans (€b)	815	824	833	863	897	932
Consumer credit (€b)	149	141	140	143	147	151
Residential mortgage loans (€b)	843	851	853	877	903	931
Non-performing loans as % of total gross loans	3.8	4.1	3.9	3.4	3.0	2.9
Deposits (% year)	7.8	1.0	3.7	5.2	4.3	4.3
Loans/deposits (%)	118	117	113	111	110	109
Total operating income (€b)	146	149	155	173	192	211

Source: ECB, Oxford Economics

Table 9 — Insurance

	2011	2012	2013	2014	2015	2016
Life gross premium ($b)	46	41	40	41	43	44
% year	*-9.5*	*-11.0*	*-3.5*	*4.1*	*3.8*	*3.8*
Life gross claims payments ($b)	38	32	28	26	27	28
Life claims ratio (%)	*82*	*79*	*70*	*63*	*62*	*62*
Non-life gross premium ($b)	103	104	104	106	108	111
% year	*9.2*	*1.1*	*-0.1*	*1.6*	*2.3*	*2.2*
Non-life gross claims payments ($b)	67	68	68	69	70	72
Non-life claims ratio (%)	*65*	*65*	*65*	*65*	*65*	*65*
Profits (€b)	6.9	7.2	7.9	8.4	8.9	9.5

Source: Oxford Economics

Table 10 — Asset management

	2011	2012	2013	2014	2015	2016
Total assets under management (€b)*	614	642	663	690	712	730
% year	*-13.1*	*4.6*	*3.2*	*4.1*	*3.2*	*2.5*
Bonds (€b)	59	67	66	66	64	63
Equity (€b)	119	120	125	139	155	169
Fund of funds (€b)	89	87	85	84	84	85
Hedge (€b)	0.8	0.8	0.8	0.8	0.7	0.7
Mixed (€b)	30	30	29	29	30	31
Money market (€b)	316	338	357	370	379	381

Source: Oxford Economics, Lipper FMI

*UCITS and non-UCITS assets

Germany

Key issues and highlights

- **Momentum in the German economy has slowed and we believe that the economy contracted in the final quarter of 2012.** But we do not anticipate this to mark the start of a sustained period of falling output, and we expect GDP to grow by 0.8% in 2013. With large German banks remaining healthy, we forecast lending to non-financial businesses and households to grow by 1.8% in 2013.
- **Despite its recent loss of momentum, we still expect the German economy to have nominal GDP growth comfortably above the Eurozone average.** We expect house prices to rise, at a time when they are falling slightly across the Eurozone as a whole. This is expected to enable Germany's non-life business insurance to average close to 3% growth in 2012 and 2013 (Table 12).
- **Germany's life insurance sector has been struggling to grow in recent years.** However the strength of the labour market should support growth of 2.8% in 2012 and 3.5% in 2013 (Table 12).
- **We expect all segments of the German asset management industry to have seen their AUMs to grow in 2012 (Table 13) – with the exception of money-market funds and property funds.** Money-market funds are expected to have seen their assets fall by a further 14.7%, as negative real returns cause investors to allocate funds to other asset classes. Property funds are expected to have seen their assets fall for a third year running, with a decline of 1.4% in 2012. However, with the German property market looking increasingly buoyant, we expect property AUMs to rise in the coming years as investors seek both capital gains and rental income higher than bond yields.

Table 11 — Banking

	2011	2012	2013	2014	2015	2016
Total assets (€b)	8,467	8,567	8,756	8,986	9,213	9,436
Total loans (€b)	3,246	3,312	3,368	3,505	3,653	3,817
Business/corporate loans (€b)	1,368	1,405	1,440	1,523	1,621	1,710
Consumer credit (€b)	229	226	228	236	244	252
Residential mortgage loans (€b)	806	816	823	837	861	886
Non-performing loans as % of total gross loans	3.3	3.0	2.7	2.6	2.6	2.5
Deposits (% year)	3.4	3.3	3.6	3.8	3.7	3.7
Loans/deposits (%)	99	98	96	96	97	98
Total operating income (€b)	127	138	144	154	167	185

Source: ECB, Oxford Economics

Table 12 — Insurance

	2011	2012	2013	2014	2015	2016
Life gross premium ($b)	115	117	120	124	127	130
% year	*-0.3*	*1.7*	*2.7*	*3.0*	*2.8*	*2.6*
Life gross claims payments ($b)	68	75	89	92	94	96
Life claims ratio (%)	*59*	*64*	*74*	*74*	*74*	*74*
Non-life gross premium ($b)	136	140	145	149	154	158
% year	*8.7*	*2.8*	*3.5*	*2.7*	*3.0*	*3.0*
Non-life gross claims payments ($b)	121	116	112	112	112	115
Non-life claims ratio (%)	*89*	*83*	*77*	*75*	*73*	*73*
Profits (€b)	1.5	1.3	1.5	1.7	1.9	2.0

Source: Oxford Economics

Table 13 — Asset management

	2011	2012	2013	2014	2015	2016
Total assets under management (€b)*	469	496	518	540	561	583
% year	*-9.8*	*5.7*	*4.5*	*4.2*	*3.9*	*4.0*
Bonds (€b)	96	109	109	108	107	104
Equity (€b)	121	130	143	154	163	175
Fund of funds (€b)	58	61	63	65	67	68
Hedge (€b)	0.9	1.0	1.1	1.1	1.2	1.2
Mixed (€b)	80	87	95	102	109	116
Money market (€b)	29	24	22	21	21	21
Property (€b)	84	83	85	89	93	97

Source: Oxford Economics, Lipper FMI

*UCITS and non-UCITS assets

Country forecast tables

Italy

Key issues and highlights

- **Non-performing loans held by Italian banks rose sharply to 9.1% of outstanding loans in September 2012.** We now expect a further rise to 10.2% in 2013, which would represent the highest level in 14 years. In light of the rapid deterioration in credit quality and the weak economic outlook, it is perhaps not surprising to find that Italian banks were expecting to further tighten credit conditions applied to corporate loans in Q4 2012, according to the Bank of Italy's Bank Lending Survey. With the economy forecast to contract by 1.1% next year, tighter credit conditions will make it even harder for companies to expand in the near term.
- **Italian life premiums are expected to have contracted again in both 2012 and 2013, with falls of 12% and 4% respectively, as five years of flat household disposable incomes continue to take their toll on business (Table 16).** After such a poor performance, the industry is likely to take steps to at least partially rebuild. We expect premium growth to average 1.9% in 2014–16, a little below the 2.3% growth forecast for non-life.
- **Italian AUMs are expected to have grown by 4% in 2012.** This is driven by a 17.4% rise in bond AUMs as ECB action to cap yields drew investors into bonds which were yielding as much as 6.5% in July 2012 (Table 17). Now that this one-off adjustment has been made, bond AUMs, which account for half of the total, are expected to grow by 2.6% in 2013. Consequently, with money-market, hedge and mixed funds expected to see their AUMs continue to decline, Italian AUMs are expected to be flat this year.

Table 14 — Banking

	2011	2012	2013	2014	2015	2016
Total assets (€b)	4,070	4,290	3,983	4,052	4,151	4,269
Total loans (€b)	2,379	2,386	2,276	2,342	2,442	2,541
Business/corporate loans (€b)	894	856	851	880	927	974
Consumer credit (€b)	64	60	60	61	62	64
Residential mortgage loans (€b)	368	366	368	375	382	390
Non-performing loans as % of total gross loans	8.1	9.5	10.2	8.6	6.9	5.5
Deposits (% year)	-3.9	6.8	3.0	4.1	4.5	4.8
Loans/deposits (%)	170	160	148	146	146	145
Total operating income (€b)	80	79	81	85	93	102

Source: ECB, Oxford Economics

Table 15 — Insurance

	2011	2012	2013	2014	2015	2016
Life gross premium ($b)	105	92	89	90	92	94
% year	*-13.9*	*-12.0*	*-4.0*	*1.7*	*1.9*	*2.0*
Life gross claims payments ($b)	35	32	33	35	38	40
Life claims ratio (%)	*33*	*35*	*37*	*39*	*41*	*43*
Non-life gross premium ($b)	51	50	53	54	55	57
% year	*6.0*	*-1.0*	*5.0*	*1.5*	*2.6*	*2.9*
Non-life gross claims payments ($b)	12	16	21	25	30	35
Non-life claims ratio (%)	*25*	*32*	*40*	*47*	*55*	*62*
Profits (€b)	1.0	1.1	1.1	1.1	1.2	1.3

Source: Oxford Economics

Table 16 — Asset management

	2011	2012	2013	2014	2015	2016
Total assets under management (€b)*	308	321	323	334	352	372
% year	*-13.4*	*4.0*	*0.7*	*3.5*	*5.2*	*5.8*
Bonds (€b)	128	150	154	162	171	180
Equity (€b)	50	51	53	57	64	70
Fund of funds (€b)	32	35	37	39	42	44
Hedge (€b)	0.9	0.7	0.6	0.5	0.5	0.5
Mixed (€b)	56	54	53	53	53	55
Money market (€b)	41	30	25	23	22	22

Source: Oxford Economics, Lipper FMI

Netherlands

Key issues and highlights

- **The short-term outlook for the Dutch economy remains challenging.** Activity is forecast to contract by 0.4% in 2013 following an estimated 0.9% fall in 2012. The household sector is likely to feel the brunt of the downturn, as wages continue to decline in real terms. Reflecting this weakness, we forecast consumer loans to contract by 0.2% in 2013, while residential mortgage loans remain broadly stable.
- **Non-life insurance premiums are expected to be flat in 2013** and rise by below 2% in 2014 and 2015, as the continued falls in house prices weigh on business (Table 21).
- **We expect life premiums to grow by 5% in 2012 and 2013** as they continue to recover from the 31% fall seen between 2008 and 2010. This recovery is due to disciplined underwriting, lower expense bases and more cost-effective sales platforms (Table 21).
- **We expect AUMs to have grown by 6% in 2012,** due mainly to growth in equity AUMs thanks to expectations that ECB action has stabilized the Eurozone (Table 22). AUM growth is expected to slow to 5% in later years, as non-core bond markets prove more attractive to yield-hungry investors.

Table 17 — Banking

	2011	2012	2013	2014	2015	2016
Total assets (€b)	2,425	2,480	2,483	2,524	2,595	2,675
Total loans (€b)	1,366	1,381	1,381	1,404	1,446	1,492
Business/corporate loans (€b)	602	622	630	656	687	719
Consumer credit (€b)	28	27	27	28	28	29
Residential mortgage loans (€b)	375	373	373	379	388	400
Non-performing loans as % of total gross loans	2.7	3.5	2.9	1.6	1.1	0.9
Deposits (% year)	4.8	5.3	4.1	4.1	4.8	4.8
Loans/deposits (%)	158	151	145	142	140	137
Total operating income (€b)	49	52	54	56	60	65

Source: ECB, Oxford Economics

Table 18 — Insurance

	2011	2012	2013	2014	2015	2016
Life gross premium ($b)	29	31	32	33	33	34
% year	*9.3*	*5.3*	*5.0*	*1.1*	*1.7*	*2.1*
Life gross claims payments ($b)	33	33	32	30	28	28
Life claims ratio (%)	*113*	*106*	*99*	*92*	*85*	*81*
Non-life gross premium ($b)	28	27	27	27	28	28
% year	*8.1*	*-3.6*	*0.0*	*1.1*	*1.9*	*2.7*
Non-life gross claims payments ($b)	19	18	18	18	19	19
Non-life claims ratio (%)	*68*	*68*	*68*	*68*	*68*	*68*
Profits (€b)	7.5	7.6	8.2	8.8	9.3	9.7

Source: Oxford Economics

Table 19 — Asset management

	2011	2012	2013	2014	2015	2016
Total assets under management (€b)*	60	64	67	70	73	76
% year	*-9.2*	*6.0*	*4.5*	*4.7*	*4.5*	*4.4*
Bonds (€b)	15.5	15.8	15.9	15.8	15.7	15.4
Equity (€b)	25.7	28.1	29.9	32.0	34.2	36.6
Fund of funds (€b)	12.6	13.4	14.0	14.6	15.3	15.9
Hedge (€b)	0.5	0.4	0.3	0.2	0.2	0.2
Mixed (€b)	6.0	6.2	6.7	7.2	7.7	8.2
Money market (€b)	0.2	0.2	0.2	0.2	0.2	0.2

Source: Oxford Economics, Lipper FMI

*UCITS and non-UCITS assets

Country forecast tables

Spain

Key issues and highlights

- **Non-performing loans (NPLs) continue to rise, reaching a new high of 10.7% of outstanding loans in September 2012.** With the economy expected to remain in recession throughout 2013, it is likely that NPLs will continue to climb. But the establishment of the so-called "bad bank" means that these distressed loans will start to be removed from bank balance sheets over the coming year.
- **We expect non-life insurance premium income to fall by 8% during the course of 2012 and 2013 (Table 21).** This reflects a 2.1% contraction in nominal GDP and a 14% fall in house prices over the period.
- **It seems unlikely that life premiums will repeat the 15% rise seen in 2011, given the weakness of the Spanish economy.** We forecast an average rise of 4.7% in 2012 and 2013 (Table 21).
- **The Spanish fund management industry has suffered from being at the epicentre of the Eurozone crisis in 2012. Consequently, we expect AUMs to have fallen by 4.7% in 2012 – a year in which Eurozone-wide AUMs are forecast to have risen by 9.6% (Table 22).** The fall in assets is focused on Spanish bond funds, which will have seen a remarkable 66% contraction since the global financial crisis started in 2007. Over the same period, Spanish property funds will have seen their AUMs decline by 50%. We think they could fall by a further 4% in 2013, before starting to recover in 2015/16 as value investors are tempted into the Spanish market.

Table 20 — Banking

	2011	2012	2013	2014	2015	2016
Total assets (€b)	3,400	3,402	3,153	3,168	3,220	3,296
Total loans (€b)	1,783	1,660	1,593	1,608	1,660	1,717
Business/corporate loans (€b)	944	885	849	872	914	956
Consumer credit (€b)	201	186	179	177	179	183
Residential mortgage loans (€b)	627	593	563	558	564	572
Non-performing loans as % of total gross loans*	7.8	11.5	15.5	9.8	7.5	5.7
Deposits (% year)	-5.0	-6.1	1.3	3.5	5.0	5.0
Loans/deposits (%)	124	123	116	113	111	110
Total operating income (€b)	101	93	92	101	108	116

Source: ECB, Oxford Economics

*The forecast rise in NPLs will be limited by the transmission of assets to the Asset Management Company (AMC)

Table 21 — Insurance

	2011	2012	2013	2014	2015	2016
Life gross premium ($b)	42	44	46	46	47	48
% year	*14.9*	*4.5*	*4.9*	*1.4*	*1.6*	*1.9*
Life gross claims payments ($b)	13	16	21	25	28	33
Life claims ratio (%)	*30*	*37*	*45*	*53*	*60*	*68*
Non-life gross premium ($b)	42	39	38	39	39	40
% year	*4.7*	*-5.9*	*-2.5*	*0.6*	*2.1*	*2.5*
Non-life gross claims payments ($b)	27	26	25	24	24	25
Non-life claims ratio (%)	*65*	*65*	*64*	*63*	*62*	*63*
Profits (€b)	7.5	7.6	8.2	8.8	9.3	9.7

Source: Oxford Economics

Table 22 — Asset management

	2011	2012	2013	2014	2015	2016
Total assets under management (€b)*	84	80	80	84	87	90
% year	*-17.6*	*-4.7*	*0.9*	*4.2*	*3.7*	*3.8*
Bonds (€b)	36	32.7	34.6	37.5	39.8	41.9
Equity (€b)	11	10.9	10.8	11.9	13.0	13.9
Fund of funds (€b)	12	11.6	11.1	10.8	10.6	10.4
Hedge (€b)	0	0.4	0.4	0.5	0.5	0.5
Mixed (€b)	11	10.2	9.7	9.4	9.3	9.3
Money market (€b)	8.7	9.5	9.6	9.6	9.7	9.7
Property (€b)	4.5	4.3	4.1	4.1	4.3	4.4

Source: Oxford Economics, Lipper FMI

*UCITS and non-UCITS assets

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