# The recovering economy: an environment of continuing uncertainty

## Key findings from an independent programme of research

**February 2015**

# Executive summary

## Despite a wealth of indicators highlighting an improving economic environment in the UK, a number of uncertainties remain. The highly competitive UK market, sluggishness of the Eurozone economy, and potential path of UK interest rates all present distinct challenges for individual businesses. The upcoming General Election potentially adds a further note of uncertainty.

How a rise in interest rates impacts an economy that is still in recovery mode is clearly an important factor in the sustainability of growth. Bank base rate has been held at the current, historic, low of 0.5% since March 2009. It has of course been well sign-posted that when interest rates eventually start on an upward course, they are likely to rise in a gradual way, before settling at a level that would still be relatively low in historical terms. In some respects, only the specific timing of the first and subsequent movements in interest rates has really been in question.

So, in order to understand how the economy is likely to fare, once the interest rate environment changes, it is important to understand how sensitive individual UK businesses may be to the initial increases in interest rates that will take place. Moreover, if the path of interest rates does follow the course expected, what tangible impact will this have on the business community? In theory, it could have an influence on a number of different aspects of the way individual businesses think and operate as well as, more directly, on their finances and cash flow and the trade credit risk to which they may be exposed.

Business insurance specialist, QBE, has been monitoring business perceptions of risk, and the associated corporate risk management agenda, since 2013 and is pleased to share the findings from this, the third, wave of its Business Risk Sentiment Survey – which includes analysis on the potential impact of interest rate changes. Interviews with 376 key 'risk' decision-makers from small, medium sized and larger businesses were conducted in November and December of 2014.

The latest survey results underline the complexity of the risk management challenge currently facing individual businesses and confirm that risk profiles are in a state of continuous flux. Many businesses have taken on a range of 'completely new' risk exposures over the last six months. And most risk decision-makers expect the likely course of interest rates over the next two to three years to have a tangible effect on at least one aspect of their own business. From the feedback given in the first two waves of the Business Risk Sentiment Survey, it has been apparent that many business risk decision-makers acknowledge a need to strengthen, enhance and support their approach to managing risk. The latest findings provide ample evidence that a continuing investment in risk management systems and processes will be important if businesses are safely to navigate the next stages of economic recovery.

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# Key research findings

- Nearly one in four (23%) businesses perceive that the overall level of risk has increased over the last six months. In contrast, however, around one in six (17%) perceive the overall level of risk to have reduced over this period. Accordingly, the net balance of businesses (i.e. those reporting an increase less those reporting a reduction) has fallen significantly from 15% to 6%.
- Nearly four in ten (37%) businesses have gained exposure in the last six months to 'completely new' areas of risk. Just over one in five (21%) have 'new' exposure to market or product risk. Nearly as many (20%) have exposure to 'new' strategic risk.
- Perceptions of heightened competitor activity and market pricing risk continue to drive business perceptions of the 'overall' level of business risk. Concerns about a lack of availability and quality of skills and talent have increased over the last six months.
- A perceived lack of confidence is still the aspect of the UK economic environment that is of most concern to businesses. However, the proportion of businesses citing interest rates is growing steadily; over one in five (22%) now see interest rates as the aspect of the UK economic environment that is of most concern.
- Nearly one in four (23%) of our respondents indicate that an increase in interest rates of up to 0.5% would start to have a tangible impact on their own business. And nearly one in two (47%) report that an increase of up to 1.5% would start to have a tangible effect.
- A gradual increase in Bank base rate over the next two to three years is likely to have an impact on more than eight in ten (85%) businesses. A more cautious approach to spending decisions (cited by 48%), as well as an increased focus on levels of working capital and cash flow (48%) are likely to be high on the agenda. In addition, over one in three (36%) expect to see increased trade credit risk within their own customer base.
- Over eight in ten (82%) respondents expect to increase at least one aspect of their business investment in the next 12 months. Nearly one in two (49%) expect to be recruiting additional skilled staff.

**37% of businesses** have gained exposure in the last six months to **'completely new'** areas of risk

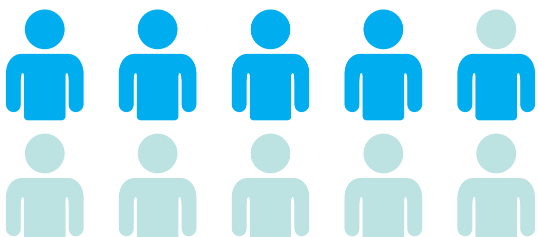
1 in 4 businesses perceive that overall level of risk has **INCREASED**

**1 in 5** now see interest rates as the aspect of the UK economic environment that is of most concern



A gradual increase in Bank base rate over the next two to three years is likely to have an impact on more than **eight in ten (85%)** businesses

**nearly half**



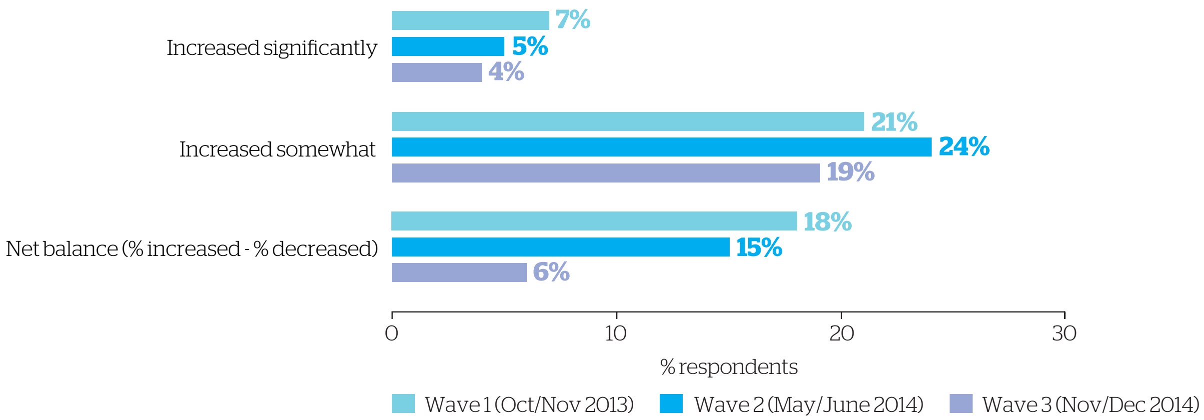
of respondents expect to be recruiting extra staff in the next **12 months**

# Competitive market pressures remain strong

## Over the last six months, the risk environment in the UK appears to have been a little more settled than that reported in previous waves of the survey.

Whilst nearly one in four (23%) respondents indicate that the overall level of risk has increased over the last six months, around one in six (17%) report an improvement. Taken together, this represents a relatively small net balance of respondents (6%) who feel that they are operating in a more risky environment now than was the case six months ago – a statistic that has fallen quite significantly on the corresponding figure six months ago.

### Perceptions of the overall level of risk faced by companies (in last 6 months)



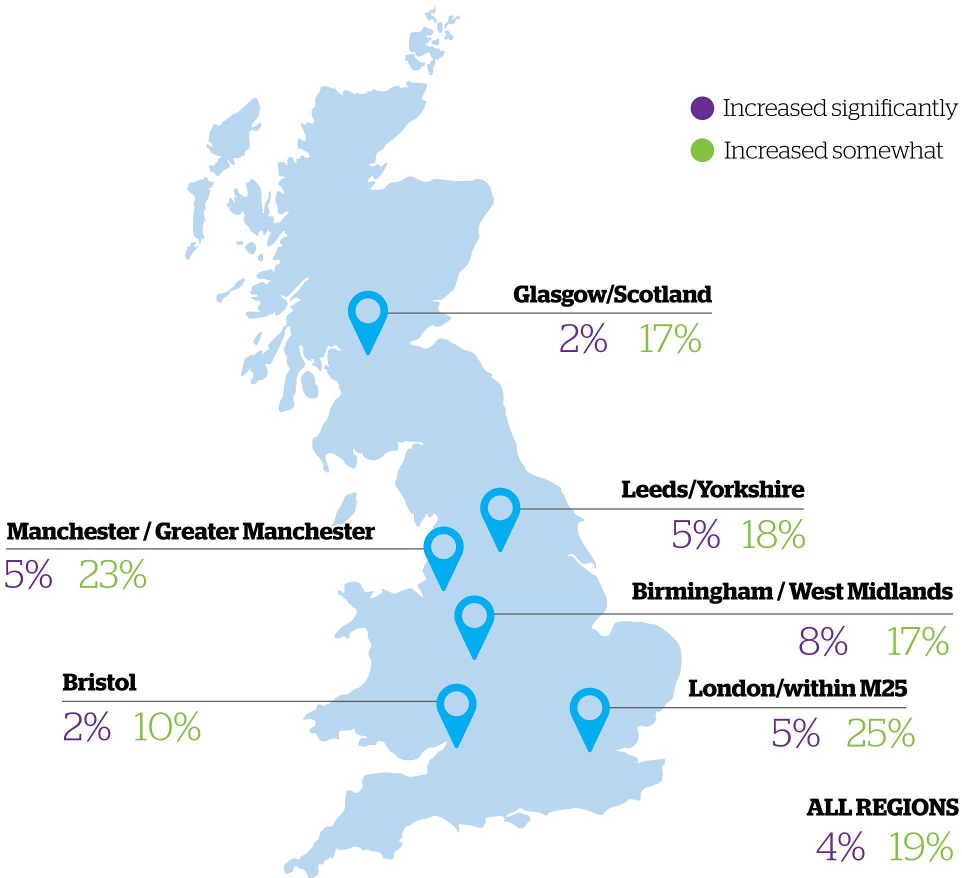

Note: the net balance is the proportion of businesses reporting an increase in risk less the proportion reporting a decrease in risk

Across the UK, perceptions of overall risk have increased in four of the six regions covered by the survey. Notably though, in Bristol and Glasgow/Scotland the percentage of businesses currently reporting an increase in overall risk is more than counterbalanced by the proportion indicating a decrease.

Similarly, perceptions of overall risk have increased in five of the industry sectors covered by the survey, most particularly Financial Services. However, in Manufacturing/Engineering the percentage of businesses reporting a decrease in overall risk marginally outweighs the proportion indicating an increase. Moreover, in Leisure/Catering/Entertainment, the zero 'net balance' suggests the risk environment has been unchanged over the last six months.

Indeed, the 'net balance' figures themselves show an improvement virtually across the board. Only for the London (within M25) region, as well as for the Retail/Wholesale and Business/Professional Services sectors is the 'net balance' of respondents higher than the corresponding figure reported in the previous wave of the survey.

## Perceptions of the overall level of risk faced by companies (in last 6 months)
## By region




## Perceptions of the overall level of risk faced by companies (in last 6 months)
## By industry sector

**IT / Telecoms / Media**
**3%** Increased significantly
23% Increased somewhat

**Manufacturing / Engineering**
**2%** Increased significantly
15% Increased somewhat

**Leisure / Catering / Entertainment**
**7%** Increased significantly
17% Increased somewhat

**Building / Construction**
**8%** Increased significantly
18% Increased somewhat

**Financial Services**
**7%** Increased significantly
24% Increased somewhat

**ALL SECTORS**
**4%** Increased significantly
19% Increased somewhat

**Business / Professional Services**
**4%** Increased significantly
22% Increased somewhat

**Retail / Wholesale**
**2%** Increased significantly
20% Increased somewhat

# What is driving perceptions of risk

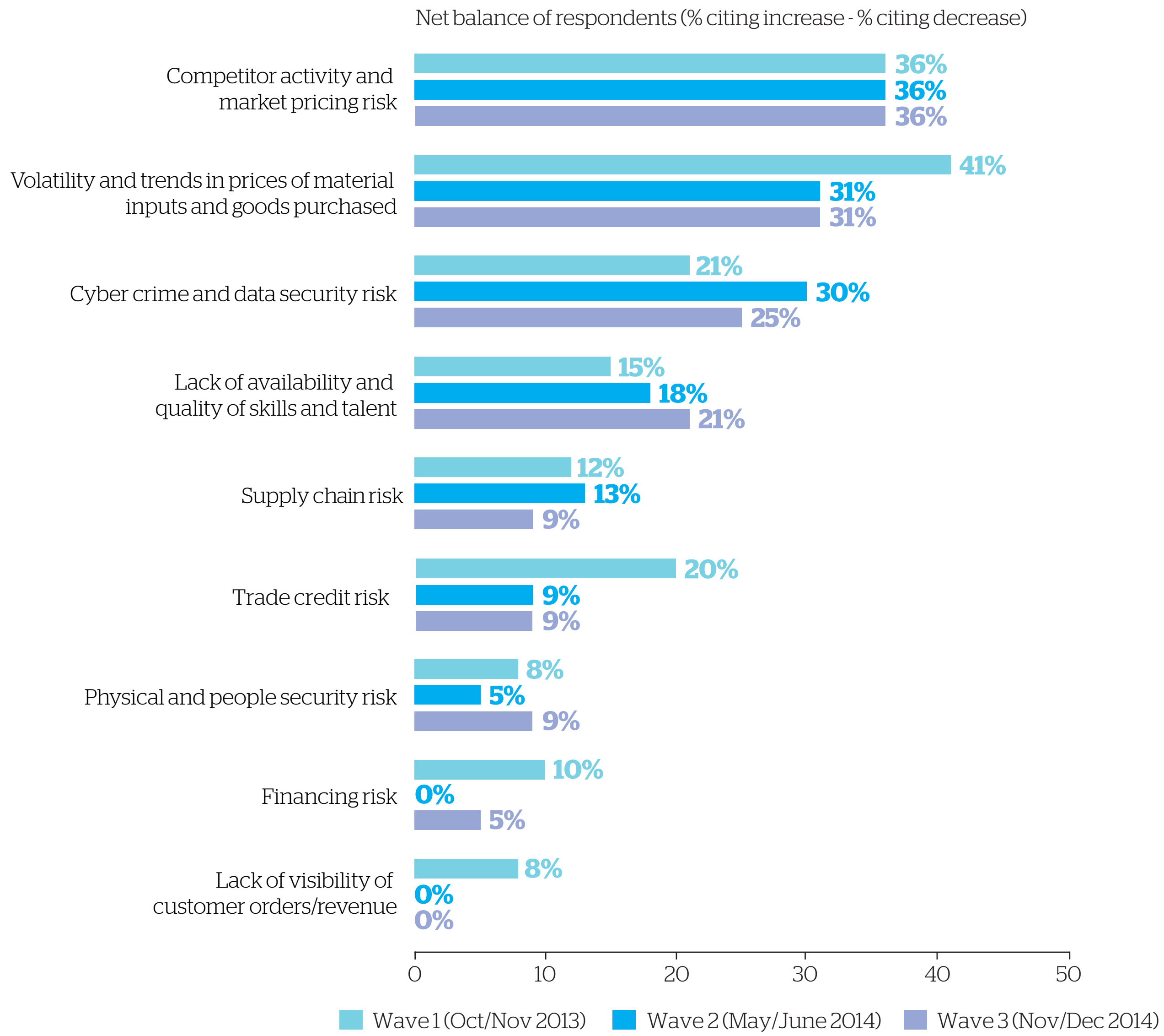
## The Business Sentiment Survey suggests two reasons why perceptions of the overall level of risk have proved relatively 'sticky' in comparison with the improving economic backdrop.

The first of these relates to the continuing competitive pressures within the UK market environment.

Intensifying competitor activity and market pricing risk continues to be a key force driving overall perceptions of risk. A net balance of 36% of respondents see competitor activity and market pricing risk as having increased over the last six months, an unchanged picture from six months ago, and indeed from a year ago as well.

In contrast, concerns about the lack of availability and quality of skills and talent are growing steadily. Over one in four (27%) businesses cite skills shortages as a risk that has increased over the last six months; and the 'net balance' on this indicator has increased over the three waves of the survey, initially from 15% at the end of 2013 to 21% currently. On a sector basis, the concern about the availability and quality of skills and talent is reasonably well spread across the range of sectors, spiking marginally for Building/Construction.

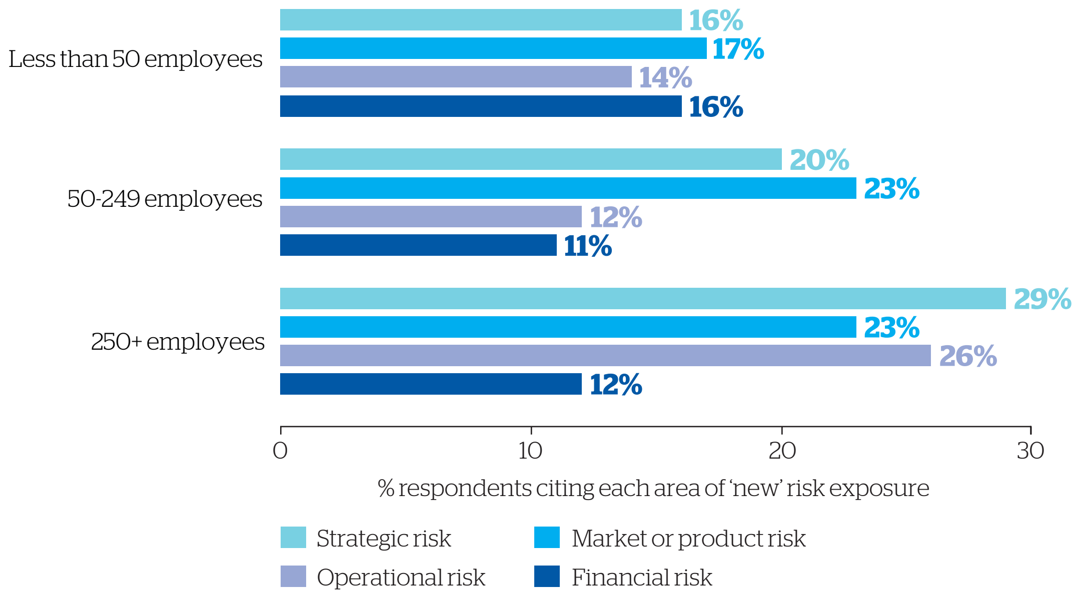
### Perceptions of key risks faced by companies (in last 6 months)



A second factor behind the relative stickiness of perceptions about the overall level of risk is that many businesses have responded to the challenging environment by extending their risk exposure. Nearly four in ten (37%) risk decision-makers indicate that they have gained exposure, over the last six months, to 'completely new' areas of business risk.

Just over one in five (21%) businesses have gained exposure to 'new' market or product risk in the last six months; and one in five (20%) have taken on 'new' strategic risk. Perhaps not surprisingly, it is the larger companies in our survey (i.e. those with 250+ employees) that are the most likely to have taken on 'new' risk, although the smallest companies (those with 5-49 employees) are the ones that have most frequently taken on 'new' financial risk.

## Exposures gained to 'completely new' areas of business risk (over last 6 months)

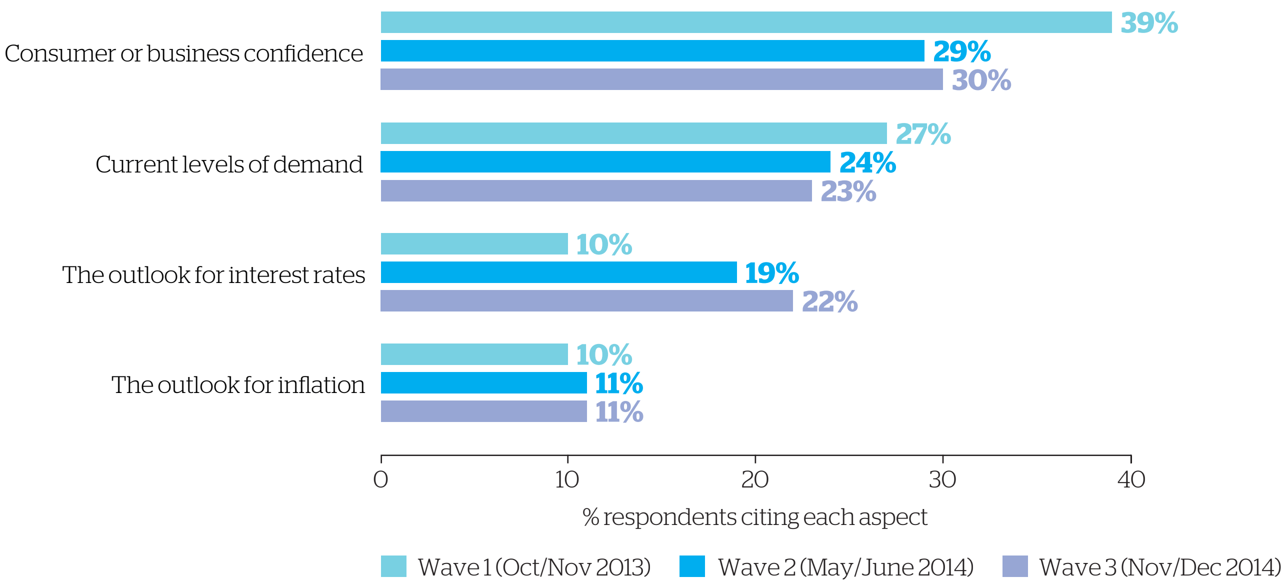



# FOCUS: Interest rates

## As the evidence grows about the robustness of UK economic recovery, concerns about the level of confidence and order levels appear to have faded somewhat. In their place, however, has come steadily growing unease about the outlook for interest rates.

For over one in five (22%) businesses, it is the outlook for interest rates that is currently the aspect of the UK economic horizon that is of most concern. For the smallest companies in our survey (i.e. those with 5-49 employees), interest rates are as frequently cited as the primary concern as levels of confidence.

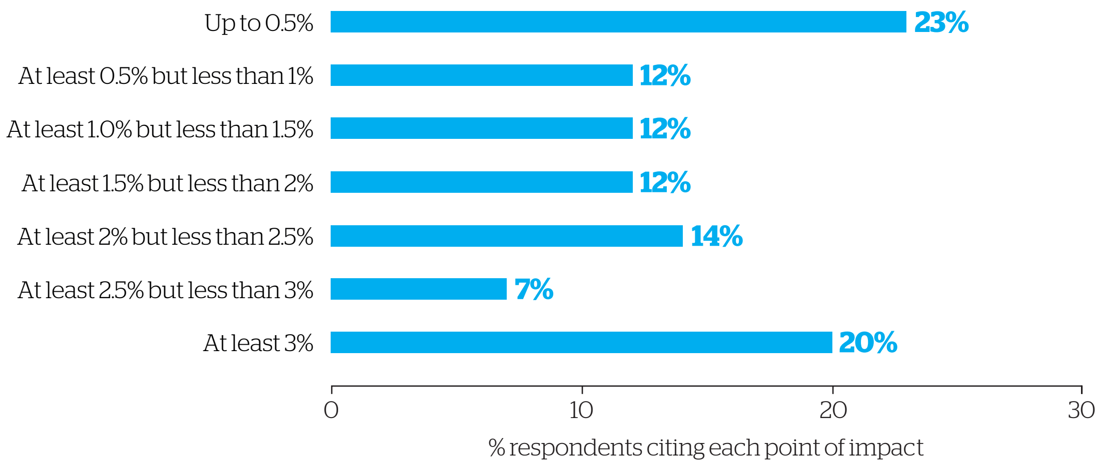
### Aspects of the economic outlook of most concern to businesses




So, if interest rates rise as expected, what is the impact likely to be? The Business Risk Sentiment Survey provides some clear evidence, both of the degree of sensitivity that individual businesses have to a change in interest rates, as well as to the specific impacts the expected rise in interest rates will have on different aspects of business thinking and operations.

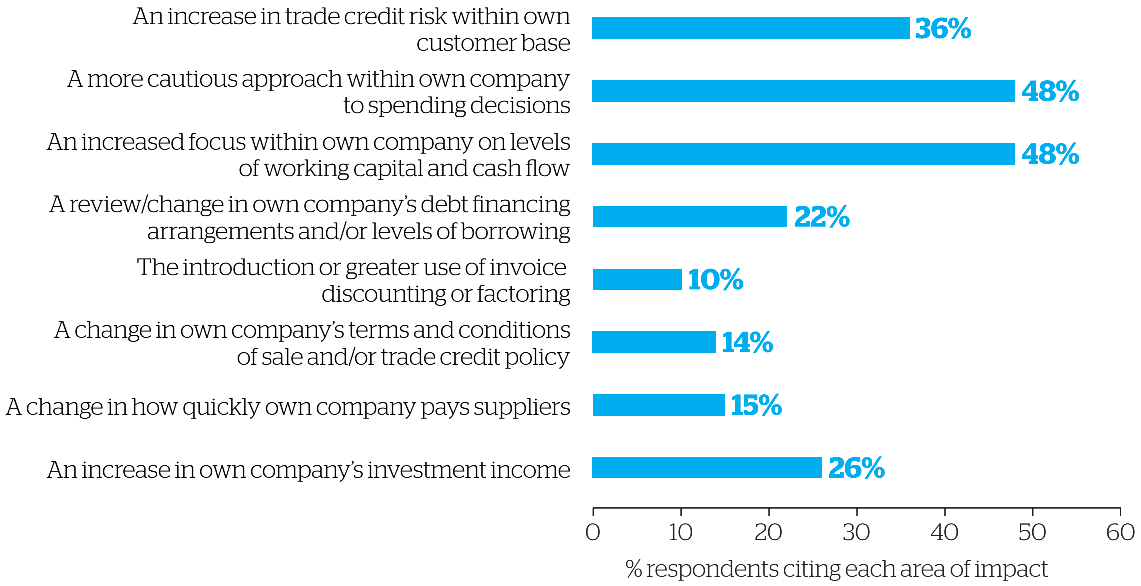
The feedback from our respondents suggests that many businesses are sensitive to potential increases in interest rates. Nearly one in four (23%) decision-makers indicate that an increase in interest rates of up to 0.5% would start to have a tangible impact on their own business; and nearly one in two (47%) suggest that an increase of up to 1.5% would start to have a tangible effect. Businesses with less than 50 employees appear to be amongst the most sensitive to initial changes in interest rates.

## Level of increases in interest rates that would start to have a tangible effect on individual businesses




And should the Bank base rate follow its expected path over the next two to three years, and settle at around 2%-3%, most (85%) of the decision-makers contributing to our survey anticipate that this would have an impact in relation to at least one aspect of their own business. Highest on the agenda, according to our respondents, is likely to be a more cautious approach within their own company to spending decisions (cited by 48% of businesses), as well as an increased focus on levels of working capital and cash flow (also cited by 48%). Notably, however, over one in three (36%) decision-makers would expect to see an increase in trade credit risk within their own customer base.

## Potential areas of impact for increases in interest rates

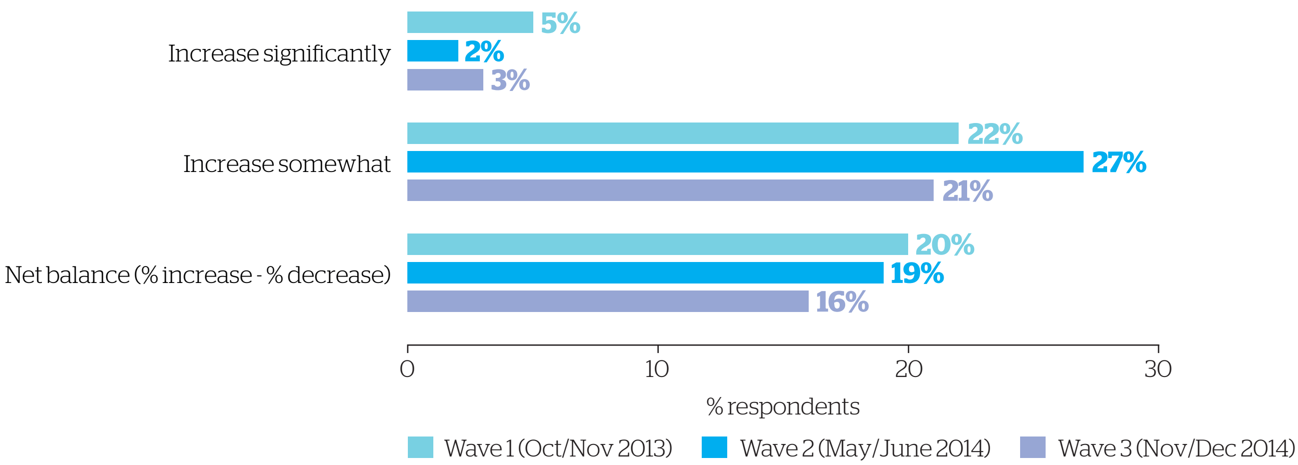



Detailed analysis of the survey results confirms a degree of variation in the relative importance of individual impacts from region to region and also by sector. However, the most consistent differences are by size of company: the smallest companies (5-49 employees) are the most likely to experience an impact in each of the eight areas prompted.

# Business investment intentions remain strong

In view of the competitive market conditions and outlook for interest rates it is perhaps not surprising that expectations of the overall level of risk in the next six months are relatively little changed in comparison with Waves 1 and 2 of the survey (as shown by the 'net balance' figures).

### Perceptions of the overall level of risk (in next 6 months)

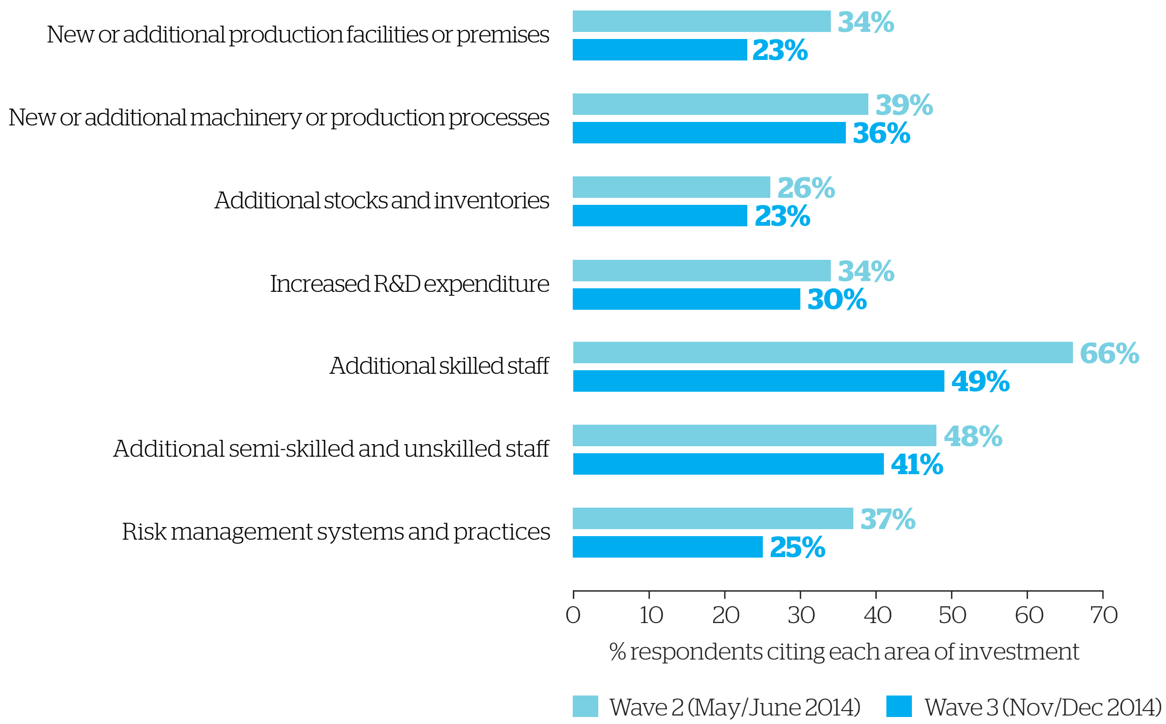



Across the individual sectors the expectation is still for the overall level of risk to increase over the next six months, most strongly so in Leisure/Catering/Entertainment, Financial Services and Retail/Wholesale. The regional picture is also fairly consistent, with a 'net balance' of businesses in each region of between 13% and 18% expecting an increase in overall risk over the period.

Despite the concerns that risk decision-makers have about the economic outlook, the latest survey results suggest that over eight in ten (82%) businesses expect to be increasing their investment (in one or more of the seven areas we put to them) in the next 12 months. Most notably within this overall picture, nearly half (49%) our respondents expect to be increasing their investment in skilled staff.

> Only one in four businesses are expecting to increase their investment in risk management systems and practices at a time when perceptions of the overall risk outlook remain understandably sticky.

**Expected areas of business investment (in next 12 months)**




Whilst, at first sight, the figures appear quite positive, in reality each of the investment categories is a little down on the corresponding figures reported in the previous survey. It may be that concerns about the path of interest rates are already beginning to have an impact on investment plans. Equally, this may also be because the particularly bullish investment plans reported in the last survey have, at least partly, been implemented by survey respondents. What is notable, however, is that only one in four businesses are expecting to increase their investment in risk management systems and practices at a time when perceptions of the overall risk outlook remain understandably sticky.

# QBE viewpoint

## A focus on Trade Credit

Our research reveals a marked sensitivity among UK businesses to even the smallest increase in interest rates. In particular companies expect their working capital and the creditworthiness of their customers to be impacted.

Some 36% of respondents cite an increase in trade credit risk within their own customer base as a cause for concern. Mirroring this, almost half expect an increase in rates to cause them to focus on their own working capital and cash flow, implying a contraction in their own viability.

The low interest rates that have persisted since 2008 and continued into 2015 have changed the dynamics of the business environment for many companies. Those with access to finance have enjoyed the benefits of borrowing at lower cost to fund expansion and investment. The “cost” of extending credit to customers has never been lower.

The implicit risk of course is that this has encouraged gearing beyond a level that companies would, in a more regularised interest rate environment, prudently accept. Equally, the relatively benign environment, which has led to lower than usual levels of business insolvencies, may also have led to greater extension of credit as companies have sought to recover from the economic downturn.

Trade credit receivables represent an average 40% of UK companies’ assets. Yet the de facto lending that this involves is unsecured and follows the old adage ‘a sale is not a sale until it is paid for’. So protecting this asset in turn provides invaluable balance sheet protection and safeguards profit margins – allowing suppliers of goods and services to trade with the confidence required to grow a business successfully.

As well as offering trading confidence and peace of mind, trade credit insurance provides a range of additional benefits, including a continual assessment of buyer risks with regular underwriter review of payment patterns, overdues and default. This provides an effective early warning system to businesses to avoid poorer quality debtors and to monitor and manage existing relationships, direct their marketing strategies, and respond effectively to the markets in which they operate.

The closing of 2014 and the first days of 2015 have seen a number of high profile business failures and profit warnings. Further weakening of the UK’s major trading partner, the Eurozone, coupled with downgrades of our own economic growth forecasts, demonstrate the continued fragility of the recovery. Margins continue to be squeezed and payment terms extended, leaving businesses susceptible to being starved of cash. Companies offering unsecured trade credit to their customers would be prudent to explore the benefits and protection that credit insurance can deliver.

# How the research is conducted

The interviews for the Business Risk Sentiment Survey are conducted and analysed for QBE by an independent research agency.

The job title of individual respondents contributing to the survey varies from organisation to organisation, but each of our contributors confirms that he or she is personally involved in decision-making about managing risk.

The research is focused on 7 key industry sectors (defined by SIC codes) and 6 specific UK regions (defined by post code).

| INDUSTRY SECTORS COVERED | REGIONS COVERED |
|---|---|
| Business/Professional Services | Birmingham/West Midlands |
| Building/Construction | Bristol |
| Financial Services | Glasgow/Scotland |
| IT/Telecoms/Media | Leeds/Yorkshire |
| Leisure/Catering/Entertainment | London (within M25) |
| Manufacturing/Engineering | Manchester/Greater Manchester |
| Retail/Wholesale | |

Companies targeted for interview have a minimum of 5 employees and a maximum of 1,000 employees. Within these parameters, interviews are spread across three company size categories: 5-49 employees; 50-249 employees; 250+ employees.

The results for the majority of questions are presented on an unweighted basis. However, for reasons of comparability of the results from wave to wave, the results for the questions focusing on the overall level of risk are weighted to an equal spread by company size.

For the latest wave of the survey, interviews were conducted in November and December 2014, following a number of pilot interviews completed at the end of October.

# About QBE

QBE is a business insurance specialist. We understand the risks businesses face and support organisations from a diverse range of sectors in managing and mitigating their risk enabling them to realise their objectives.

An A+ rated insurer, we have the appetite and capacity to provide cover for businesses of all sizes.

Our extensive product range includes:

| | |
|---|---|
| Accident and health (inc commercial PA and business travel) | Pharmaceutical and medical |
| After the event insurance | Political risk and terrorism |
| Commercial crime | Product guarantee and recall |
| Commercial combined | Product protection |
| Contractor all risks/EAR | Property |
| Energy, offshore and onshore | Reinsurance |
| Entertainment and leisure industry | Scheme underwriting facility |
| Environmental impairment liability | Specie |
| Financial and professional liability (Cyber Liability, Director's & Officer's, Professional Indemnity) | Surety/bonds |
| General liability (Employer's Liability, Public Liability, Tradesman) | Trade credit |
| Marine | Warranty and GAP |
| Motor Commercial (inc fleet, haulage, bus and coach, motor trade) | |

## Risk management

Effective risk management is a feature of all successful organisations – and it's one of our key underwriting considerations. We work closely with businesses to improve their systems and processes; minimising their exposure to risk and helping to reduce the frequency and severity of any losses.

## We stand by our claims

Inevitably, claims do occur. That's when businesses really discover the value their insurance company delivers. We pride ourselves on our positive attitude and proactive approach to claims management. Our claims teams have a deserved reputation for the professional, efficient and sympathetic way they work with brokers and clients when losses are incurred.

## Local knowledge

UK underwriting offices: London, Belfast, Birmingham, Bristol, Chelmsford, Glasgow, Leeds, Manchester and Stafford.

## To find out more

For more information about QBE and how we can help your business, please visit our website **www.QBEeurope.com**

**QBE European Operations**
Plantation Place, 30 Fenchurch Street, London EC3M 3BD
tel +44 (0)20 7105 4000
www.QBEeurope.com



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