This edition of Precious Plastic explores the impact of the ‘credit crunch’, the crisis in the banking sector and the downturn in the global economy on the UK consumer finance market and considers whether similar trends are being witnessed across continental Europe.

This year’s publication also presents the findings of the first PricewaterhouseCoopers’ (PwC) Credit Confidence survey. This provides an important ‘street-level’ perspective on everyday debt repayment and credit issues and is coupled with the thoughts of financial institutions on the outlook for the consumer credit market in this volatile and challenging lending environment.

This report highlights the fact that a significant proportion of individuals are already unable to meet their debt obligations with an even greater number concerned about their ability to repay their debts in the future.

Against a backdrop of volatility in food and energy costs, rising unemployment and falling house prices, there continues to be a dependency on unsecured borrowing in the UK with consumers increasingly using bank overdrafts to bridge the gap between living expenses and income. This is set alongside an apparent reluctance among many UK households to either moderate their spending habits or restructure existing debt to make it more affordable. This ‘head-in-the-sand’ mentality, with many individuals failing to appreciate the downward spiral that unsecured debt can begin, suggests that debt default levels for financial institutions will rise before the situation begins to improve. Clearly, this does not bode well for either consumers or their lenders, with arrears and default management skills likely to become even more highly valued in the years ahead.

There may be some hope on the horizon following the Bank of England’s significant reduction in base rates. Whether this will prevent issues arising for those already labouring under high levels of debt, however, is uncertain. Already this year’s unprecedented volatility has resulted in the London Interbank Offer Rate (LIBOR) – the rate at which banks lend to each other and on which many mortgages are priced – remaining significantly above the Bank of England base rate.

Furthermore, even with a lower base rate, the banks have contracted lending – particularly for mortgages. Many consumers may not be able to refinance to discount/promotional rates and could therefore still face higher mortgage financing costs despite the rate cuts.
Despite the ‘credit crunch’, total household borrowing in the UK has continued to rise over the past year. Total indebtedness increased by 5.4 per cent over the 12 months to 30 September 2008, reaching almost £1.5 trillion.

While the growth rate in UK secured lending has dropped, unsecured lending continues to grow at around 6 per cent per annum. This growth in unsecured lending is being driven, primarily, by an increased use of revolving credit lines, such as bank overdraft facilities.

Levels of unsecured borrowing in the credit-hungry UK and US far outstrip those of any established mainland European credit market.

Net interest margins have improved in the credit card market following a widening of spreads between base rates and average APRs. However, this is unlikely to translate into a sustainable improvement in profitability due to rising defaults and collection costs. Furthermore, with proposals to restrict the sale of Payment Protection Insurance (PPI), one may expect APRs or other charges to increase further to compensate for this loss of income.

One in six UK consumers responding to the recent PwC Credit Confidence survey felt that they were unable to cover their current credit commitments. This increased to nearly one in three when consumers were asked about their expected ability to meet their debt repayments in the future.

As banks are unwilling to lend at the same loan-to-value ratios as they did in the past, households with little or no equity in their property could end up on higher Standard Variable Rates (SVRs) when they look to remortgage at the end of an incentivised period. Even with the recent lowering of base rates by the Bank of England, this is unlikely to stimulate a ready supply of credit as banks continue to restrict lending to manage their balance sheets. If interest rate cuts are not sustainable, this could lead to the ‘waterfall effect’ (see figure 12) where consumers are forced to bridge the gap between expenditure and disposable income through the use of other forms of credit.

The maxim ‘ignorance is bliss’ seems to prevail among many UK consumers with relatively few willing to rein-in everyday expenditure or consolidate and/or restructure their borrowings.

Only 21 per cent of respondents in the PwC Credit Confidence survey appeared worried about the future availability of credit. This was despite being questioned in late September following the collapse of Lehman Brothers and the wide-spread banking sector crisis. Given the intense publicity surrounding the ‘credit crunch’ and its after-shocks, this suggests that UK consumers still do not fully understand the probable long-term impact of the market turmoil.

Personal insolvencies increased by 8.8 per cent in the UK in the third quarter of 2008 compared with the second quarter. They are now running at an annual rate of over 100,000. Individual Voluntary Arrangements (IVAs) appear to have stabilised at around 40,000 per annum. However, full bankruptcies increased by 12.1 per cent between the second and third quarters of 2008.

The UK is witnessing a huge increase in the use of charging orders. These convert unsecured loans that are in default to secured debt. Charging orders are up from around 10,000 in 2000 to some 97,000 in 2007 (a 45 per cent increase on 2006). This could further reduce homeowner equity which combined with UK housing market weakness offers the prospect of reduced recoveries for lenders from defaulting customers.

Despite steps already taken by lenders to tighten their lending criteria and the recent interest rate reductions, the PwC Credit Confidence survey indicates that financial institutions are in for a bumpy ride. Higher levels of charge-offs on unsecured lending in the UK are anticipated over the next two to three years.

Methodology

PwC commissioned YouGov to survey a sample of UK consumers on their attitudes to various aspects of the UK credit market. In the first survey, conducted on 5 September 2008, YouGov asked 3,958 people 10 consumer finance related questions. Shortly after the Lehman Brothers collapse, PwC recommissioned YouGov to ask one of the questions from the initial survey again (to 2,253 consumers over the weekend of 20 September). The aim of this was to gauge if sentiment had changed in regards to consumers’ concern regarding the availability of credit for future purchases. YouGov carried out the surveys online, targeting from their database a selection of individuals that is representative of the UK population. The responding sample is subsequently weighted in order to provide a representative reporting sample and this weighting is based upon census data.
 Consumers hooked on credit

The key message to emerge from the recent PwC Credit Confidence survey is that the ability to service unsecured credit is already a major concern for many UK consumers and will increasingly be so in the future.

Conducted by YouGov among approximately 4,000 UK consumers to assess attitudes to credit market conditions, the survey found that while the majority of UK consumers still feel comfortable with their current levels of debt, a worrying minority (16 per cent) are already unable to meet their current debt obligations (Figure 1). When those same respondents were asked about their ability to repay debts in the future, the number of those worried increased to nearly 30 per cent (Figure 2). This is a concern likely to be compounded by the fact that around 14 per cent of those same respondents also expect to use more credit in the run-up to Christmas. This sends a strong warning signal to the market that while consumers recognise that they may be overstretching themselves, some are still prepared to continue doing so.

The survey reveals very similar results between different socio-economic groups. This highlights another key characteristic of the current ‘credit crunch’; it is affecting everyone, even the comparatively wealthy.

PwC believes that this is partly because higher income earners, on the back of a rising housing market, have leveraged themselves through large mortgages. Now faced with higher mortgage costs and falling property values, they are also encountering affordability issues.

Despite this burden of borrowing, only 14 per cent of respondents in the PwC Credit Confidence survey appear to have considered restructuring their debt to make it more affordable or to take the more drastic step of entering into IVAs (Figure 3). This suggests that consumers do not think ahead and only consider action when there is a very real prospect of default.

Riding out the recession

In PwC’s original survey on 5 September 2008, 26 per cent of respondents expressed a concern about the availability of credit for future purchases (Figure 4). Yet in a follow-up survey on 20 and 21 September 2008, immediately after the collapse of Lehman Brothers and in the midst of unprecedented volatility in banking stocks, only 21 per cent of respondents claimed to be concerned about credit supply. However, there did appear to be increased uncertainty, with the number of respondents answering neutrally rising significantly.

These results indicate that many UK consumers do not fully understand the probable long-term impact of the recent market turmoil on their personal finances. It also suggests that UK consumers generally feel that they will be able to ‘grin and bear’ the current situation and survive into more prosperous times. This demonstrates that although many UK consumers are already struggling to meet their debt burden, the full extent of the situation may not yet be evident. Therefore, despite steps already taken by lenders to tighten their lending criteria, defaults for financial institutions look set to worsen before they improve.
Unsecured borrowing bucks the trend

Total household borrowing in the UK has continued to rise over the past year, despite the spectre of recession and the impact of the ‘credit crunch’ on the UK lending market. Total indebtedness of the UK population was almost £1.5 trillion on 30 September 2008, up from almost £1.4 trillion on 30 September 2007 (Figure 5). However, the Bank of England’s adjusted rate of borrowing growth slowed to 5.4 per cent in the year to 30 September 2008 (Figure 5), from 10.2 per cent during the same period in 2007. According to the Bank of England’s adjusted annual growth rates, secured borrowing growth fell from 11 per cent to 5.3 per cent between 30 September 2007 and 30 September 2008 while growth in unsecured borrowing held firm at around 6 per cent over the year.

Outstanding balances on unsecured credit lines increased by £20 billion in the year to 30 September 2008 (Figure 6) to account for 16 per cent of the total UK lending market (18 per cent in 2007).

As seen in Figure 6, after a period of high annual growth, much lower growth rates were experienced in 2006 and 2007. Despite the current economic climate, unsecured borrowing continues to increase at similar rates to the previous two years.

Credit cards held at bay

A glimmer of light in the UK’s debt darkness is the fact that consumers appear to be containing their credit card usage, with credit card balances reaching a plateau over the past three years (Figure 7).

According to figures from the British Bankers’ Association, outstanding credit card balances decreased at a compound annual rate of 0.4 per cent in the three years to 30 September 2008 to £65.3 billion. The number of cards in issue also appeared to be stabilising at approximately 68 million, with over 60 per cent of these cards being active. However, this masks a worrying trend over the 12 months to 30 September 2008, where an increase in outstanding balances and a fall in the number of credit cards have led to an increase in average borrowing per card of 4.7 per cent.
Consumers turn to revolving credit

With the increase in unsecured lending not being driven by credit card borrowing nor, by an increase in personal loans it is probable that a large proportion of the increase is being fuelled by more reliance on other revolving facilities such as overdrafts. Limited data exists to fully understand what is behind the growth in unsecured borrowing but a review of new lending by line of credit goes some way towards providing an answer (Figure 8).

Gross new lending on non-revolving unsecured credit in the 12 months to August 2008 fell by 15 per cent, compared with the same period to August 2007. The use of revolving credit over the same period increased by 2.4 per cent.

The fall in non-revolving borrowing is explained by both supply- and demand-side factors. On the supply-side, most banks have tightened lending criteria in order to manage liquidity and general uncertainty about the credit worthiness of consumers in the current environment. On the demand-side, consumer confidence in the housing market is likely to be impacting demand for particular non-revolving products. For example, in respect of direct secured personal loans, new lending fell by 77 per cent in August 2008 compared with the same month in 2007.

New borrowing on revolving products has increased in recent months. This can partly be explained by the tightening of credit criteria on non-revolving loans as consumers are forced to substitute these with more expensive revolving credit facilities. In addition, revolving credit lines that have already been granted can be accessed quickly in times of difficulty.

According to the statistics underlying Figure 8, new lending on credit cards increased by 3 per cent in the 12 months to August 2008, compared with the 12 months to August 2007. However, this does not explain the significant growth in overall unsecured balances.

Considering the 220 billion increase in unsecured lending recorded in the 12 months to 30 September 2008, this analysis tells only part of the story. The data shown in Figure 8 excludes overdrafts (where public data is limited), however we believe that the consumer is likely to be moving into their overdraft facilities earlier in the month.

This would suggest, therefore, that the growth in unsecured lending is not being driven by planned borrowing, but more by UK consumers reacting to a shortfall during the month and resorting to existing revolving facilities.

We expect consumers to become more dependent on existing overdraft facilities as the economy worsens and in particular as unemployment rises.

Credit card profitability remains under pressure

Average credit card interest rates increased from 15 per cent in September 2007 to 16.1 per cent in September 2008. However, while the spread between base rates and average APRs has increased, it needs to be recognised that there has been a divergence between LIBOR and the base rate (due to this divergence, the net interest yield is shown using both LIBOR and the base rate as the cost of funding in Figure 9).

Net interest yields on credit cards (after charge-offs) have declined significantly over the past decade as financial institutions have competed heavily for market share. However, the last 12 months have seen an increase in net yields. This appears to be the result of falling default rates in 2007 and 2008 as changes in acceptance criteria applied by financial institutions in previous years have taken effect. In addition, as APRs have increased in 2008 these have more than off-set any increase in the cost of funding. Nevertheless, the increase in net yields may be artificial as banks are now conscious of the impending economic downturn feeding through to consumers and a potential increase in charge-offs. Further pressure on profit margins will come from proposed changes around the sale of PPI.

The Competition Commission has proposed that lenders will not be able to sell PPI at point of sale. If this happens we believe it is likely that APRs or other charges will increase to compensate for the loss of income.

Managing credit card profitability

Over the last few years, credit card companies have seen their margins impacted by increased competition and rising costs. Combined with the effects of the current harsh economic outlook, issuers have a difficult path ahead of them in terms of maintaining profitability and growth.

To achieve profitable growth in the future, issuers will need to have a more detailed understanding of both their revenue and cost drivers. They must be able to pinpoint exactly where there is the potential to flex their current approach and also recognise where this will not be effective.

On the revenue front, key issues for credit card companies to consider include identifying the aspects of their products or services customers value most highly, and analysing which aspects could be removed without adversely affecting customer behaviour.

Credit card companies also need to ensure that sales incentives are designed to drive the acquisition of profitable customers and not merely to augment customer numbers. In addition, thought needs to be given to the direction future regulation will take so that pre-emptive action can be taken if necessary.

Cost issues to consider include achieving cost control without affecting the level of service provided. To do this effectively, it is necessary for companies to understand the true breakdown of costs between their fixed, semi-fixed and variable expenditure.

This would replace the blanket approach to cost cutting which is often used with its application of a percentage reduction to all aspects of overhead. This strategy is rarely effective and customer service is often impacted negatively as a result.

If a credit card company can achieve a full understanding of how its costs move with revenue then it is possible to make economies which will most directly benefit margins going forward and exclude those areas where rationalisations will be less effective. Gaining this knowledge will also provide issuers seeking to grow through acquisition with a methodology to analyse the cost base of a target.

This will enable a more effective identification and achievement of cost synergies.

How PwC can provide support

PwC has compiled a variety of benchmark and comparator databases to identify not only areas where companies deviate from leading practice but also the potential size of that deviation. This is supported by the deep analytical ability of the firm’s broad range of industry and technical experts.

As a stand-alone service or integrated with the firm’s rapid activity analysis capability, it can provide management with a unique, cross-functional insight into their operations, identify the value customers attach to individual services and outputs, and assist in developing pricing strategies to maximise revenues.

The firm can also ensure that all proposed client actions and strategies are reviewed in the context of the more stringent regulatory regime and increased governmental scrutiny which is being applied as the financial sector responds to the global financial crisis.
IVA log-jam stores up trouble?

Personal insolvency statistics produced by the Insolvency Service for the third quarter of 2008, reveal an increase of 8.8 per cent in the total numbers of personal insolvencies in the UK compared with the second quarter of 2008. This means that personal insolvencies now have an annual run rate of over 100,000 (Figure 10).

The number of IVAs appears to have stabilised at around 40,000 per annum, although there was a 12.1 per cent growth in bankruptcies compared with the second quarter. This growth has been driven partly by an increased unwillingness among banks to agree terms of IVAs with insolvency practitioners. This appears to be forcing some customers into full bankruptcy proceedings.

Nevertheless, because financial institutions and insolvency practitioners continue to be locked in debates to determine what a fair return should be for both the lender and the insolvency practitioner, it is still unclear whether there is a potential backlog of IVAs that will surface in the coming year.

One thing is certain however, if IVAs are not processed this leaves highly-indebted customers with a reduced number of choices. Eventually, they will have to turn to bankruptcy or agree another form of repayment.

Borrowers could accept a restructured repayment schedule for an outstanding debt with a financial institution. While total statistics are not published, PwC estimates a market total of around 100,000 Debt Management Plans (DMPs) this year and therefore the true extent of affordability issues may be somewhat hidden from the public domain. However, unemployment and falling net income pose key threats to consumers' ability to meet the obligations of their IVAs and DMPs. Whilst banks are being tough on IVAs, this is being translated into an increase in DMPs rather than bankruptcies.

Order of the day

There are some indications that problems with over-indebtedness are simply manifesting themselves in other ways. While an IVA is a customer-led initiative, we are now seeing financial institutions increasingly taking the lead to protect their assets by applying to the court for a charging order. A charging order allows a creditor for an unsecured loan that is in default to tie that loan to an asset that is owned by the debtor.

In many cases the asset will be residential property but orders can also be granted against land, commercial property or other assets. A charging order does not allow the creditor to repossess the property or asset but, if the property or asset is sold, the charge has to be paid to the creditor before any of the proceeds of the sale are passed on to the debtor. If there are already loans secured on the property or asset before the charging order is registered, for example a mortgage, then the original loan will be repaid first. Therefore, a charging order only has value as long as a positive equity value remains in the underlying asset.

Figure 11 highlights the fact that charging orders increased significantly in 2007 to nearly 100,000. This represents a 45 per cent increase on the previous year, with court applications for charging orders increasing by a similar amount, up 42 per cent to around 130,000 over the same period.

At the current rate, banks are applying to the court for over 500 charging orders against customers’ properties every working day. In a falling property market, many people are faced with the prospect of declining or negative equity with individuals at risk of handing over any equity in their property to a financial institution if they have over-borrowed on other credit facilities.

Personal insolvency management

The dramatic rise in the level of personal insolvencies in recent years has left both individuals and lenders grappling with a variety of new challenges and considerations.

Individuals in financial difficulty and facing possible bankruptcy need to obtain the best possible advice on the increasingly wide variety of options available to them such as IVAs and DMPs, taking in the threat of charging orders along the way.

For example, a key concern for a professionally qualified debtor is that they risk losing their professional status, and their livelihood, if made bankrupt. They must therefore look for an alternative solution to their debt problems. This is most likely to be in the form of an IVA. This not only avoids the stigma of bankruptcy and provides a flexible approach to asset realisation and payment schedules, but can also mean that an individual can continue to trade and will not face debarment from professional associations.

A prima consideration for creditors in the current climate is the need to manage their exposure to losses. As credit losses increase then clearly there will be growing pressure on maximising recoveries. However, the administrative burden of personal insolvencies is increasing all the time and the cost of evaluating notices of creditors’ meetings regarding bankruptcies and insolvencies is significant.

How PwC can provide support

PwC can assist creditors in finding straightforward and practical solutions for insolvency cases of any size. By providing leading-edge expertise and running specialist bankruptcy processing centres, PwC is able to help creditors manage costs, increase recoveries and encourage the payment of dividends to creditors as early as possible.

For individuals, PwC’s services include general personal insolvency advice around the various insolvency options that are available, as well as acting as Trustees in Bankruptcy, negotiating IVAs and DMPs, and dealing with charging orders.
Increases in monthly mortgage and living costs (see page 13) have been adding significant pressure to consumers’ disposable income. As consumers turn to credit cards and overdrafts to bridge the gap in disposable income, there is a concern that when these facilities are exhausted, some consumers may be forced to use more expensive forms of credit. This will increase their monthly outgoings further with the potential to sink them deeper into debt. This can produce a ‘waterfall effect’ – already observed in the US (Figure 12).

Figure 12: The ‘waterfall effect’ – illustrative example

In addition, rising unemployment and consumers’ fear of losing their own job will put further pressure on disposable income and expenditure respectively. Ultimately, this combination of factors is likely to lead to increased defaults on mortgages and other lines of credit.

Historically, growth in UK household spending has been less volatile than that of disposable income growth (Figure 13). This suggests that UK consumers are generally prepared to reduce their savings rates and/or increase their borrowing levels in order to maintain spending levels.

Traditionally, during economic downturns, consumers would resort to their savings and, if required, increase their borrowing as a temporary measure until the economic situation improved. Over recent years, as the UK has not been a nation of savers, many households have no financial cushion to ease the pain of higher outgoings. Customers may therefore attempt to increase their use of unsecured credit, but may find that once they reach the limit on their existing credit lines, the availability of further credit is significantly restricted by reluctant lenders.

Confidence in the consumer finance market is not helped by the fact that, due to the recent slump in house prices, a significant number of UK homeowners are now faced with the prospect of negative equity.

House prices to October 2008 fell by around 15 per cent from their peak in August 2007, with economic forecasts suggesting that a further 15 per cent to 20 per cent decrease could be expected before the UK reaches the bottom of this current downturn.

Those most likely to be exposed to negative equity are households that have moved during the last two years, since they will generally have had less time to build up equity. In addition, it is interesting to note that over 331,000 mortgages were advanced as ‘interest only’ in 2007. These borrowers will certainly have had no chance to decrease their exposure to house price falls.

What does this mean for mortgage holders?

Some 520,000 households were due to roll-off fixed rate deals between January and June 2008. Those unable to obtain a new incentivised fixed rate, discounted or ‘tracker’ deal and left on their lender’s SVR are likely to face higher repayments since there is no certainty that the recent base rate cuts and subsequent mortgage rate reductions will lead to lower interest rates for borrowers in the medium- to long-term.

With around four million households coming off incentivised deals over the next two years, we present two contrasting scenarios;

• In the first scenario, mortgage interest rates remain high as the impact of recent rate cuts might be unsustainable with borrowers faced with higher costs as their incentivised mortgage periods come to an end.

• In the second, mortgage interest rates are lower as recent rate cuts prove sustainable, and for illustration, we have assumed an average reduction of one percentage point passed on by lenders.
What does this mean for mortgage holders?

Scenario 1 – the long-term impact

Figure 14 shows the increase in mortgage costs that households are likely to face assuming that the SVR over this period is not significantly reduced by Bank of England efforts in November 2008 to decrease the cost of borrowing. Over 290,000 households that took out fixed rate mortgages during the six months to June 2008 would suffer an average monthly increase of £72 in mortgage costs when their incentive period ends during the six months to June 2010 if they transfer to their lender’s SVR.

Scenario 2 – rate cut reprieve

Based on an illustrative assumption that recent cuts in base rates would lead to a one percentage point reduction in average SVRs, Figure 15 shows that households that took out fixed rate products are likely to be protected from the recent spiralling cost of mortgage credit.

Under this scenario the same 290,000 households that were faced with a monthly increase of £72 in mortgage costs would actually experience an average decrease in monthly mortgage costs of £54. However, even if these rate cuts are passed on to borrowers, there are still approximately 1.5 million households that took out fixed rate mortgages in the 12 months to December 2006 that have already suffered payment shocks in the 12 months to December 2008 if they rolled onto higher SVR rates.

The analysis shows how sensitive household monthly costs are to mortgage rates, particularly in an environment with less competitive rates being available and tighter lending criteria, compounded by falling property values and the fact that many more households are likely to be perceived as ‘high risk’ by lenders. As such, even though some customers with discounted products will be reprieved thanks to the base rate cuts, those unable to refinance could experience a payment shock as they roll onto their lender’s SVR.

The non-performing loan (NPL) market

It is worth considering the impact of the current economic climate on those financial institutions faced with a need to improve liquidity in a market where ‘cash is king’ and that are holding significant consumer credit assets that could be non-performing within the next 12 months. PwC believes that we are likely to see an increase in transaction activity as banks look to sell some of these assets.

It is likely that sales of consumer credit assets by financial institutions will focus on NPLs, although possibly not immediately as there still remains some large price expectation gaps between sellers and buyers, largely due to the carrying value of these assets by the financial institutions. Consequently, to date, sales of distressed debt in the UK have mainly been in the secondary market as opposed to being from mainstream lenders. Nevertheless, investors have recently been indicating that the size of the UK distressed debt market is somewhere between that of Germany and Spain, i.e. in excess of €50 billion.

The main drivers are likely to be:

- a lack of liquidity at financial institutions and thus a need to sell to release cash
- a lack of resources to handle the volume of new NPLs
- regulatory control

Regulation is likely to encourage financial institutions to reduce NPL ratios and improve overall capital adequacy ratios.

Buoyant market for distressed debt

In the current depressed economic environment many UK financial institutions may need to strengthen their balance sheets through the disposal of distressed debt such as NPL portfolios. At the same time, other financial institutions are recognizing this opportunity to acquire distressed debt portfolios at attractive prices. Given this burgeoning supply and demand, it is likely that the sale and purchase of consumer NPLs will increase significantly over the next few years.

The main impetus for an NPL sale is often a lack of liquidity on the part of a financial institution and the need to realize cash. The institution may also have insufficient internal resources to handle the volume of new NPLs with regulatory pressures encouraging the lender to reduce its NPL ratios and improve its overall capital adequacy.

Both NPL buyers and sellers need to be clear about the issues they are likely to face in this growing market.

Key considerations for vendors include the need to obtain the right regulatory approvals, the treatment of potential losses or gains on the sale and the level of loan provisioning attributable to a portfolio. Vendors must assess the impact of any NPL divestment from both an accounting and tax perspective and ensure the confidentiality of information provided to investors. Current holding and opportunity costs versus the selling price need to be addressed, as well as the vendor’s domestic loan servicing capacity and capabilities alongside political sensitivity and/or media interest and the reputational risk of the buyer.

Acquirers must also determine whether regulatory approvals are required and deal with any other potential barriers to entry. Buyers must consider the confidentiality of information to be reviewed and acquired and the pricing of assets – tricky in the current environment, alongside the debtors’ loan servicing capacity and capabilities. There will also always be deal structuring issues such as taxes, dividends and so on to contend with, together with purchase accounting and structuring concerns.

How PwC can provide support

PwC regularly acts for buyers and sellers of NPL portfolios providing advice on strategies and structures for a distressed debt sale or purchase and applying proven valuation methodologies.

The firm can facilitate deals through its access to an international network of distressed asset investors and support transactions with an integrated team of financial, valuation, tax and accounting specialists.
Selling NPL portfolios

Sellers will have a number of issues to overcome to successfully dispose of NPL portfolios in the current market. They will customarily be concerned with reputational risk, in that they will want to sell to a responsible investor that will seek to collect in an ethical manner and behave in accordance with good market practice.

It is clearly currently a buyers’ market. As a result, investors often drive the sale process and demand bilateral deals where possible, as well as favourable terms in the sale and purchase agreement surrounding vendor financing, representations and warranties from the seller and potentially longer put-back periods. Furthermore, due to current market conditions, investor due diligence requirements are also becoming more stringent. They will often require higher samples of loan information, especially in relation to real estate collateralised loans. A key concern for buyers is often around the relation to real estate collateralised loans. Historically, investors have often combined multiple consumer NPL portfolios into securitised Special Purpose Vehicles (SPVs). However, this practice is likely to be in decline given the current market environment.

With the demise of the securitisation market and doubts over whether it will ever bounce back, we believe that a new market trend, whereby NPL portfolios are exchanged between different financial institutions, is likely to emerge over the next three years. When one considers that much of the current credit crisis stems from the ‘contagion effect’ of banks packaging consumer credit assets into complex structured vehicles and selling them on to third parties, it is interesting to note that the fall-out from this practice is evolving into a new market for financial institutions. Now they can still buy and sell similar assets, albeit non-performing, but for very different reasons.

Once these assets have been purchased, it is common for investors to hold and work-out portfolios for at least three years, potentially selling on any residual uncollected loans thereafter. In this regard, sellers gain more comfort when dealing with investors that are planning to be long-term players, especially those with servicing platforms or strong alliances with existing collection agents. Historically, investors have often combined multiple consumer NPL portfolios into securitised Special Purpose Vehicles (SPVs). However, this practice is likely to be in decline given the current market environment.

Levels of unsecured borrowing in the UK and US far outstrip those of any established European credit market (Figure 16). Even markets that have exhibited high levels of growth in recent years, such as Spain, Greece and Ireland, have failed to come close to the levels of lending in either of these credit-hungry markets.

As in the UK, Eurozone banks have tightened credit criteria as a result of increased capital requirements, concerns over future default rates and gloomy economic expectations. Interestingly, in contrast to the UK, demand for loans among households in the Eurozone, for both house purchases and consumer credit, has been declining. According to the European Central Bank (ECB) Euro Area Bank Lending Survey in July 2008, net demand for housing loans (minus 56 per cent) and consumer credit and other lending (minus 21 per cent) was expected to decline even further, with responding banks in the ECB survey predicting that net demand for housing loans and consumer credit and other lending would become more negative during the third quarter of this year (minus 60 per cent and minus 26 per cent respectively).

Demand for loans was expected to decline even further, with responding banks in the ECB survey predicting that net demand for housing loans and consumer credit and other lending would become more negative during the third quarter of this year (minus 60 per cent and minus 26 per cent respectively).

European consumers stick with cash

Whilst many UK consumers will resort to revolving credit to maintain their lifestyle, it appears that most of their European counterparts choose not to pursue this option. The ECB Euro Area Bank Lending Survey suggests that the decrease in demand for unsecured lending in the Eurozone is being partly driven by consumers altering their buying behaviour to reduce their debt servicing burden. Decreasing consumer confidence was cited as the biggest single driver of the decrease in demand. In the survey, 27 per cent of respondents indicated that decreased spending on consumer goods was a reason for the decrease in demand for consumer credit (Figure 17). The combination of decreased demand and tightening credit standards is likely to lead to a significant fall in the level of new consumer credit borrowing in the Eurozone, in the near future.

Eurozone tightens its belt

Source: ECB, Eurostat, Bundesbank, IMF, PwC analysis

All data as at 31 December with the exception of 2008, which is 31 August

Note: “Net demand” refers to the difference between the share of banks reporting an increase in loan demand and the share of banks reporting a decline. Net demand will therefore be positive if a larger proportion of banks have reported an increase in loan demand, whereas negative net demand indicates that a larger proportion of banks have reported a decline in loan demand. (Source: ECB Euro Area Bank Lending Survey, July 2008)
Conclusion
‘Credit crunch’ consequences

The ‘credit crunch’, with its stifling of the UK economy, squeeze on UK mortgage lending and deflationary effect on house prices, is likely to be felt in the UK consumer finance market for many years to come. It has seriously undermined the confidence of consumers in terms of their ability to obtain and support additional credit at a time when the rising cost of living is forcing many individuals to rely on unsecured lending more than ever before.

In terms of managing debt, most consumers will curb their consumption and stick within sensible budgets. However, a significant minority appears unaware, unwilling, or genuinely unable to economise. Their reliance on unsecured debt could propel them down a slippery slope with serious consequences for them personally and for the unsecured debt industry as a whole.

The continued increase in consumer borrowing suggests that the UK is seeing the same ‘waterfall effect’ as experienced in the US. In addition, the PwC Credit Confidence survey has shown that while many UK consumers are either already struggling to meet their debt obligations or expect this to be the case in the future, this may not yet be fully evident in current levels of bad debt.

As the current economic climate is changing on a daily basis, it is difficult to predict with any certainty the quantum of default rates and future losses which financial institutions will report in 2009. However, many financial institutions have already expressed concerns, with a recent Bank of England Credit Conditions survey revealing that default rates and losses on defaults were larger than expected in the three months to September 2008 and they were expected to increase in the last quarter of 2008.

PwC’s own survey demonstrates the consumer’s viewpoint, with nearly 30 per cent of borrowers worried about their ability to repay personal debt in the future. It appears that both they and the lenders are now waiting for the worst.

PwC believes this could lead to continued high levels of charge-offs on unsecured lending over the next two to three years. While the media focus has mainly been on the housing market, market participants should also keep a close eye on secondary effects in the unsecured debt market. In particular, financial institutions may consider the sale of non-performing loans over the next two to three years as they look to manage liquidity.
About PricewaterhouseCoopers

The consumer credit market is undergoing a period of change, demanding participants to be more competitive and innovative. The Consumer Finance team of PricewaterhouseCoopers is a leading adviser in the consumer credit market. We offer a perspective derived from working with all types of market participants across multiple functions, including major banks, card issuers, retailers and other non-financial institutions, specialist lenders and brokers. The team has extensive experience advising and assisting clients with:

- Partnership strategies
- Distressed debt advisory
- Valuations
- Strategy and business plans
- Contract negotiations
- Market and economic analyses
- Regulation
- Due diligence
- Performance improvement
- Transaction & investment decisions

PwC's Consumer Finance team

Richard Thompson
Partner
+44 (0) 20 7213 1185
richard.c.thompson@uk.pwc.com

Peter Simon
Director
+44 (0) 20 7213 5359
peter.m.simon@uk.pwc.com

Robert Boulding
Assistant Director
+44 (0) 20 7804 5236
robert.boulding@uk.pwc.com

Peter Kuelsheimer
Assistant Director
+44 (0) 20 7804 4892
peter.kuelsheimer@uk.pwc.com

PwC's Consumer Finance Panel of Experts

John Hitchins
UK Banking Leader

Pat Boyden
Personal Insolvencies

Keith Webb
Debt/Profitability Management

Tim Ogier
Regulatory Economics

Nick Page
Transaction Services

John Hawksworth
Head of Macroeconomics

Graham Martin
UK Distressed Debt Group

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Managing in a downturn. Risk or opportunity?

At PricewaterhouseCoopers we understand that the downturn presents both risks and opportunities for our clients. From strategy to operations, and from finance through to people, we are well placed to support you with the challenges ahead.

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