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UK consumer credit in the eye of the storm

Precious Plastic 2011

Investigating trends in the UK consumer credit market.

pwc

Contents

Executive summary

The UK consumer credit market is in the eye of the storm. In the short-term, lenders are enjoying improved returns as a result of widened spreads and an easing in record levels of bad debt. However, dramatic changes to business models will be required in response to continued market contraction, rising interest rates, regulatory pressures and a continued squeeze on funding.

Are lenders sufficiently adapting to compete in a market that is no longer growing? How sustainable are UK consumer debt levels? What will happen to pricing and business models as interest rates begin to increase? How will consumers, the industry and the economy be affected by the continued constraints in the supply of credit? Who will serve the growing population of the underbanked? How will the continued march of regulation, and particularly the 'fairness' agenda, change the way the industry operates?

No longer a growth industry

Following the best part of a decade of uninterrupted growth, the UK consumer credit market is no longer a growth industry. Outstanding unsecured borrowing fell by more than £500 per household over the last year. According to our main scenario, borrowing is set to contract by a further 2-3% or £200 per household in 2011 as consumers continue to deleverage and the supply of credit remains constrained. Given the historical significance of debt fuelled consumption to the UK economy, this prolonged contraction may impede retail sales and could be a drag on economic growth.

Confidence in the future drops

The annual PwC Credit Confidence survey reveals continued weakness in consumer confidence. While there has been a marginal increase in confidence about managing existing debts, there has been a marked deterioration in confidence over the future. Confidence has been eroded further since the announcement of the Government's Spending Review. While bad debt levels are beginning to abate, consumers' lack of confidence in managing their debt should leave lenders on high alert.

How long can high debt levels be sustained?

With total household debt at around 110% of GDP, UK consumers are among the most leveraged in the world. Since the 1990s, the UK's relatively high debt levels have been set in the context of relatively low interest rates and increasing value of household assets (primarily house prices and equities). However, over the next five years, continued house price uncertainty and a likely increase in interest rates could spell trouble. Our projections anticipate that while total household borrowing may fall from 110% of GDP today to 101% by 2015, interest rates could be 3% higher. This would lead to an increase in household borrowing costs of around £45 billion at today's value and means that the average UK household would need to pay an extra £1,800 a year on interest payments alone.

Growing regulatory burden

As lenders focus on readying themselves for compliance with the Consumer Credit Directive (CCD) and the outcome of the Department for Business, Innovation and Skills (BIS) call for evidence in relation to its consumer credit review, the next round of scrutiny is already underway. The BIS call for evidence on 'managing borrowing and dealing with debt' is exploring restrictive measures including rate caps. While the industry has made significant progress in terms of transparency we believe the emphasis will now shift to fairness, simplicity and consumer understanding as regulators and consumers reject what some perceive as the tricks and traps operated by the industry in the past. Forward thinking lenders should accept this agenda and get ahead of the wave (and their competitors) by reinventing their products and business models now.

A shot in the arm

According to our projections, the record credit card bad debt levels seen over the last two years have now peaked. Over the same period spreads have widened. In the short-term, the combined effect has given the industry a much needed shot in the arm. However, although we project that bad debt levels will begin to abate, as funding costs increase over the next few years, the dam will surely burst and we'll begin to see more dramatic change in the industry. This is likely to include higher interest rates and much more widespread charging of fees.

Supply of credit to remain constrained

While UK banks are generally well capitalised, they continue to face significant funding pressures, which will constrain their capacity to lend. Between now and 2012, UK banks will need to refinance some £440 billion of maturing debt. Over the same period, the Government plans to unwind the various support mechanisms put in place following the financial crisis, for example the special liquidity scheme. We believe these funding constraints will ultimately limit the supply of credit and increase its cost to consumers. We also expect to see an increase in debt sale activity as lenders seek to unlock liquidity and value, and reduce their funding requirements.

The rise of the underbanked

The PwC Credit Confidence survey indicates that as the recovery continues, demand for credit may begin to return. However, with supply constrained, a growing proportion of consumers face the shock of being denied credit from mainstream lenders, giving rise to a large increase in the underbanked population. This will raise important questions about how this population should be serviced and will offer the potential for attractive returns to those lenders that focus on this customer segment.

Cost of credit set to increase

With supply constrained and demand creeping back, there is set to be an increase in the cost of credit. The impact of this supply/demand imbalance on the price of credit will be exacerbated by the new regulation requiring banks to hold more of their capital in more liquid (thus lower returning) asset classes. We believe these factors combined could increase the cost of unsecured credit by as much as 200 to 300 basis points over the next few years.

Smaller tickets, shorter terms

As demand for credit gradually returns, we believe that consumers (particularly the underbanked) will seek to jam jar their finances by borrowing in a more contained and controllable fashion, leading to an increase in demand for smaller ticket, shorter term borrowing. Given their cost structure, larger institutions may not be well positioned (or indeed inclined) to service such requirements. The rise of the underbanked coupled with the demand for smaller ticket, shorter term borrowing will create opportunities for non-traditional lenders such as payday lenders and point of sale credit providers.

From top line to bottom line

While many lenders have successfully shifted their focus from top line growth to managing the bottom line, more change is likely to be required to adapt to the new reality of operating in a stagnant market. Key attributes for success include gaining a better understanding and control of cost drivers (in line with other margin focused businesses such as retailers) and collections and risk management to ensure products remain competitive. Smart institutions will also be looking to unlock value from their existing customers by adopting a more scientific and segmented approach to customer value management by targeting resources where they can earn the best return. For some lenders this shift in focus may be relatively easy, though other institutions may find it harder as their people and processes have been historically geared to operating in a growth market.

Through 2010 consumers reduced their unsecured borrowing per household by

£500

Part 1: The state of the nation

1.1 Market overview

A once rapidly expanding consumer credit market is continuing to contract, creating challenges some market participants won't have experienced in their careers.

No longer a growth industry

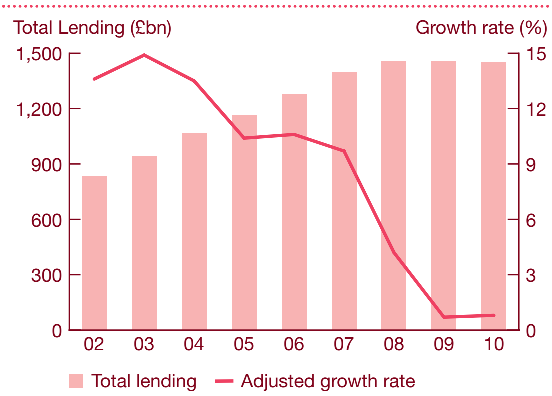
Last year, we reported that consumer credit was reaching a tipping point as ten years of uninterrupted growth came to an abrupt end. The market has now begun to shrink, with our economic analysis indicating that there will be no quick return to the era of cheap credit and the boom it helped to fuel.

Total household lending in the UK fell by £6 billion to £1.45 trillion in 2010 (see Figure 1), of this secured loans (mainly mortgages) now account for £1.24 trillion, compared to £1.23 trillion in 2009. Unsecured credit fell significantly, with outstanding balances down £13 billion on 2009 to £214 billion, equivalent to £500 per household (see Figure 2). We believe this trend is set to continue, with our main scenario predicting a further decrease of £200 per household in 2011.

This drop in lending is being driven by changes in both supply and demand. On the supply side, funding and capital constraints coupled with record bad debt levels leave lenders rationing the availability of credit and being highly selective about who they lend to. On the demand side, consumers are focused on deleveraging. While a degree of confidence has returned to the private sector, fears over public sector job losses and over house prices are leaving consumers cautious.

Projections prepared by our macroeconomics team suggest that outstanding consumer credit could decrease by 2-3% to around £210 billion in 2011, before returning to modest growth in 2012. Given the historical significance of debt-driven consumption to the economy, this prolonged contraction may be a drag on retail sales and ultimately the recovery as a whole.

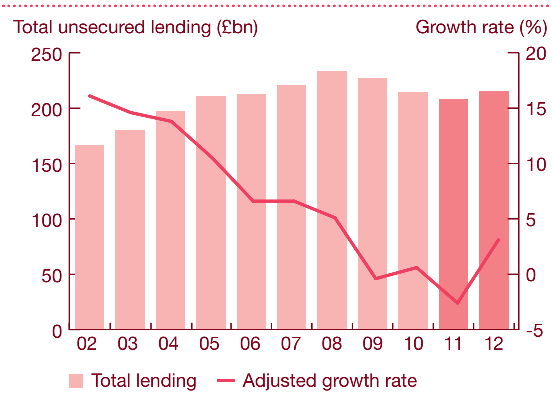
Figure 1: Total UK lending and growth rate



Note: Growth rates have been adjusted for changes in the reporting population, foreign currency revaluation adjustments and other miscellaneous items.

Source: Bank of England, PwC analysis, all data as at 30 November.

Figure 2: Total unsecured lending and PwC projections



Note: Growth rates have been adjusted for changes in the reporting population, foreign currency revaluation adjustments and other miscellaneous items.

Source: Bank of England, PwC analysis, all data as at 30 November.

New lending continues to fall

This more cautious environment is highlighted by the fall in new lending volumes in 2010, with credit card and direct unsecured loans down by 7% and 34% on the previous year respectively (see Figure 3). Store instalment credit, notable for its growth in the last couple of years, has fallen over the past year. As a number of point of sale finance providers withdraw or scale back their operations, the supply side prospects for this form of credit remain uncertain.

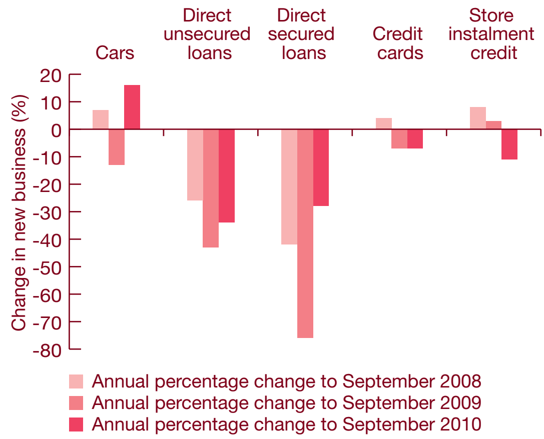
Cooling passion for plastic

Having fallen by 1.5 million in the year to September 2010 the number of credit cards in circulation has reached levels not seen since 2003, (see Figure 4). The average outstanding balance per card remains in excess of £1,000.

Demand and supply have both played a part in the reduction in the number of credit cards in circulation. Many lenders have been seeking to rationalise their products and customer bases and have reduced new customer acquisition. In turn, many borrowers have been keen to either limit the number of cards they use or to switch to a debit card instead.

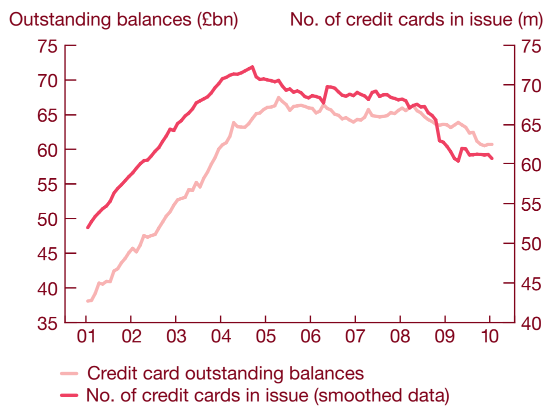
According to data produced by the UK Cards Association, average expenditure per transaction on both credit and debit cards has remained relatively flat.[1] However, the use of debit cards has increased at an even greater rate than previously forecast, with total spending of £264 billion in the 12 months to December 2009, an increase of 9.6% on the prior year. In contrast, annual credit card spending declined from £100 billion to £97 billion, the first time since 2005 this figure has fallen below the £100 billion mark.

Figure 3: Percentage year-on-year change in new lending



Source: Finance and Leasing Association, PwC analysis.

Figure 4: Credit cards in circulation and outstanding balances



Source: British Bankers' Association, PwC analysis.

Total outstanding unsecured debt is projected to fall by

2-3% in 2011

1 *UK Plastic Cards 2010*, published by the UK Cards Association.

…although falling, our projections indicate that in 2011 write-offs could still be as high as

8.5%

Record write-offs

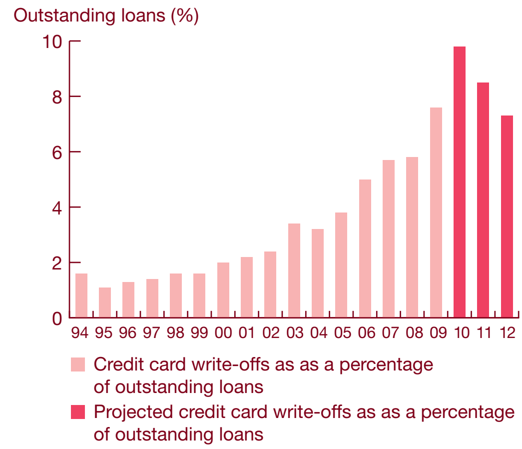
Having reached historic highs, credit card bad debt levels are begining to abate. At year end 2009, charge-offs stood at 7.6% of outstanding balances, compared with 5.8% a year before (see Figure 5). Although the industry has taken action to address the problem, our projections indicate that write-offs in 2010 could be as high as 9.8%. Bad debt levels are already beginning to come down, with the rate of reduction depending on the nature and speed of the economic recovery and the impact of rising interest rates.

Personal insolvencies peak

While personal insolvencies rose to historic highs in 2010 (see Figure 6), we anticipate that the numbers have now peaked and will begin to decrease. This is being driven by the overall contraction in the consumer credit market and the fact that lenders have adjusted their lending criteria to a more cautious environment.

Public sector job losses, and the knock on impact on the private sector, could be expected to lead to higher levels of personal insolvencies in the future. However, any impact will not be felt immediately and may be far less significant than some would assume. The nature of public sector severance arrangements may allow individuals to get on top of any financial difficulties, at least in the short-term. Job losses tend to result in insolvency where there are existing debt issues. Where this is not the case, any problems tend to centre on keeping up with payments.

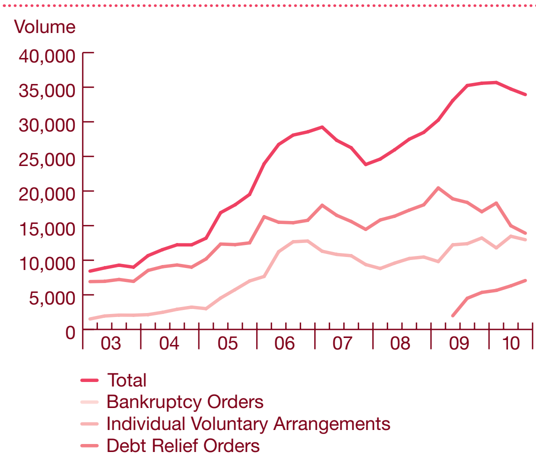
Figure 5: Credit card write-offs as a proportion of outstanding balances



Our macroeconomics team forecasts write-offs for credit cards as part of its portfolio of financial services and retail finance products. In addition, the team uses a wide variety of econometric techniques to bring new insights into potential default rates, mortgage arrears, insolvencies and foreclosures, providing assistance in valuing complex financial entities and in assessing the potential of new opportunities

Source: Bank of England, PwC analysis.

Figure 6: Quarterly number of personal insolvencies



Source: Insolvency Service, PwC analysis.

1.2 PwC Credit Confidence survey

Consumer credit confidence remains low and fragile. While there is some evidence of stabilised confidence over consumers' current debt position, concerns over the ability to meet future repayments are rising. Consumers also remain concerned over the future availability and cost of credit.

Confidence remains low and fragile

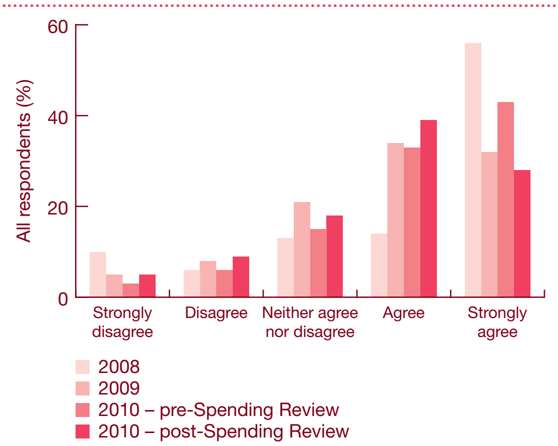
Each year in association with YouGov, we poll approximately 2,000 UK consumers regarding their attitude to borrowing,[2] their ability to pay and how easy it is to secure credit. The annual survey provides one of the most comprehensive and up-to-date pictures of the trends and drivers shaping consumer credit demand. This year we ran the survey twice, once before and again after the Government's Spending Review to assess the impact on consumer confidence.

Before the Spending Review, more than three-quarters of consumers were confident about their ability to keep up with their current repayments. Following the results of the Spending Review, this fell to similar levels to last year. In August 2010, around one in ten survey respondents (9%) were not confident about being able to meet their commitments. By November 2010, this had risen to 15%, 2% higher than in 2009 (see Figure 7).

Fears for the future grow

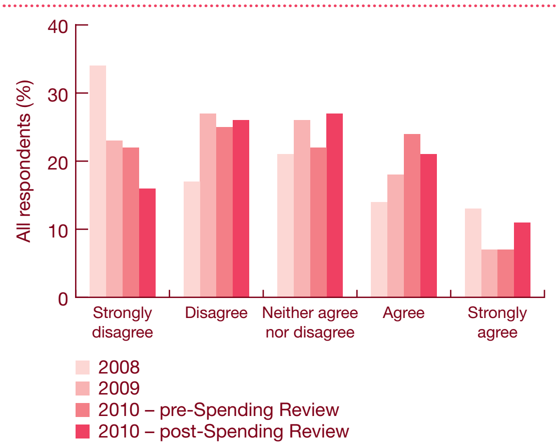
Our survey also identified growing fears over consumers' ability to maintain future repayments, with 32% of respondents now concerned about meeting their commitments, up from 25% last year (see Figure 8). In addition, the results reveal growing uncertainty, as illustrated by the marked decline in the proportion of respondents who either strongly agreed or strongly disagreed with the statement in Figure 8 since 2008.

Figure 7: I am able to make repayments on all of the outstanding credit I have



Source: PwC Credit Confidence survey.

Figure 8: I am worried about my ability to make repayments on debt in the future



Source: PwC Credit Confidence survey.

2 YouGov carried out surveys on 11-14 August 2010 and 12-15 November 2010. The surveys were conducted online, targeting a selection of individuals from YouGov's database that is representative of the UK consumers.

Against a backdrop of Government spending cuts and continuing cost-saving drives in the private sector, concerns about pay and job prospects will clearly impede any upturn in demand for credit.

In the August 2010 survey, around one in five consumers were worried about losing their job within the next 12 months. While this was broadly in line with our 2009 survey findings, 40% expected their pay to be reduced or frozen over the coming year. Following the Spending Review, this now stands at 48%, a significant rise on last year (see Figure 9). 18% of those surveyed said they were more dependent on their credit card or overdraft than in the previous three months.

Assuming the economic recovery continues, our August 2010 survey showed signs that optimism and with it greater demand for credit may begin to return. As Figure 10 highlights, post-Spending Review 66% of consumers were unwilling to fund large purchases by borrowing, this reflects a not unexpected deterioration in consumer confidence following the Spending Review.

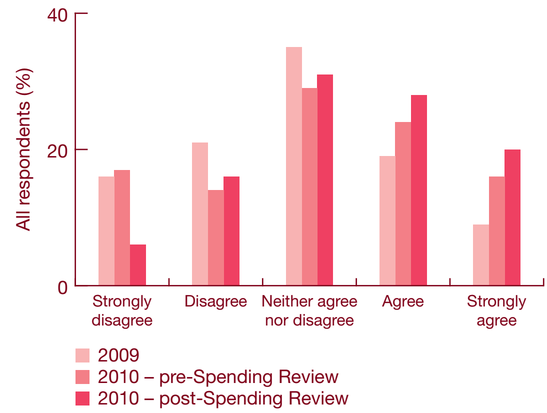
Looking after the pennies

Consumer uncertainty over the future of their finances is encouraging more people to save – 41% planning to put more aside, up from 35% last year (see Figure 11). The survey also highlights a startling generational shift, with younger people being the most likely to save more. Over 70% of 18 to 24 year olds surveyed intended to save more over the next 12 months. This is more than double the proportion of over-45s planning to increase saving. A shift away from borrowing towards saving will have critical long-term implications for financial institutions, retail spending and the wider economy.

Out of reach

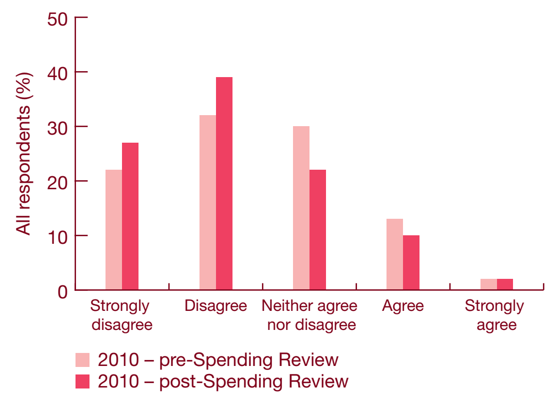
Even if demand for credit does increase, concerns over availability and affordability persist. Around one in four consumers has doubts about their ability to secure credit in the future and believe the cost of borrowing will increase in the next 12 months.

Figure 9: I expect my pay to be frozen or decrease over the 12 months



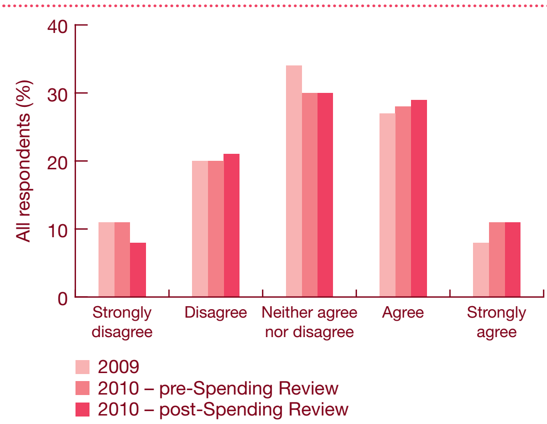
Source: PwC Credit Confidence survey.

Figure 10: Assuming this current economic recovery continues, I will be more willing to consider borrowing to fund any large purchases I am planning



Source: PwC Credit Confidence survey.

Figure 11: I intend to save more over the next 12 months



Source: PwC Credit Confidence survey.

1.3 How sustainable is the UK's consumer debt burden?

Although relatively highly leveraged, the UK's rapid rise in consumer debt over the last ten years has been in the context of low long-term interest rates and appreciating asset values (particularly housing). With house prices softening and interest rates expected to rise in the medium-term, how sustainable is the UK consumers' debt burden?

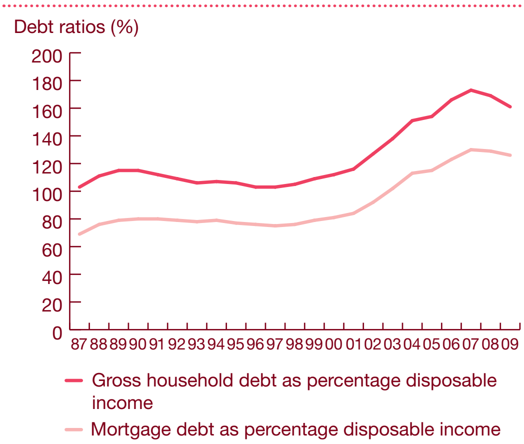
In 2009, total household debt stood at 110% of GDP making UK consumers among the most leveraged in the world. While this level of debt could appear unsustainable, two counter arguments to consider are:

- Both real and nominal interest rates (both in the UK and globally) have fallen markedly since the early 1990s, which has made it possible to service a larger debt stock relative to income levels.
- The rise in debt has been matched (or more than matched) by increases in the market value of households' assets despite the declines seen in housing and equity values since their cyclical peak in 2007.

GDP is an obvious income variable to use as a denominator in debt ratios when looking across all sectors of the economy, however, for the households it's more meaningful to look at the ratio of debt to household disposable income (i.e. after paying tax and other net transfers). Figure 12 shows this ratio for both total household debt and mortgage debt, which is the dominant element in the total (the difference between the two lines in the chart represents unsecured household credit). Whereas household debt stands at 110% of GDP when compared to disposable income houshold debt it is 160% of total.

From 2001 to 2007, household debt rose sharply as both mortgage debt and unsecured credit rose much faster than incomes, encouraged by sustained economic growth, booming house prices, low interest and unemployment rates. These relatively favourable economic conditions boosted the confidence of households in taking on debt, particularly to fund house purchases. Relative to the early 1990s recession, the recession of 2008/09 has not put nearly as much strain on household finances as interest rates and unemployment have been much lower than in the 1990s and mortgage arrears have picked up only modestly during the current downturn. For example, only around 15% of borrowers missed at least two regular repayments on their debt in 2008/09,[3] almost all of which related to small amounts of unsecured consumer credit. Only around 1% of mortgage holders had missed more than two monthly payments.

Figure 12: Key household debt ratios



Source: PwC analysis of ONS data from 2010 Blue Book.

3 *UK Wealth and Assets survey*, published by the Office for National Statistics in December 2009.

Possible increase in annual interest payments that households may have to pay over the coming years

£1,800

The relatively high levels of household debt therefore appear to be sustainable in the short-term. However, this is highly dependent on current low levels of interest rates and also the fact that house prices rallied in the year after March 2009, so avoiding too many households falling into negative equity. More recent indicators suggest that house prices have weakened in the second half of 2010 and, while the base rate has remained at historic low levels of 0.5%, margins on mortgages and other consumer debt have risen relative to the boom period of 2003-7 according to Bank of England analysis.

Eventually, the base rate is likely to go back up to more normal levels of around 5% (and quite probably higher at some points in the economic cycle). Even if it takes five or more years to climb back to these levels, interest rates on mortgages and other household debt could well be higher than before the recession, especially as higher capital ratios and other regulatory changes are likely to push up lenders' costs and reduce their currently high margins.

Figure 13: Projections of household debt

	Actual 2009	PwC main scenario projection 2015
Debt in cash terms	£1.5 trillion	£1.9 trillion
Debt as a % of GDP	110%	101%

As Figure 13 highlights, our scenario projection anticipates that household debt as a percentage of GDP will fall from 110% in 2009 to 101% by 2015, but will increase in absolute cash terms to £1.9 trillion. By 2015, it is quite possible that average interest rates on this debt might have risen by 3% (allowing for a rise in the base rate from 0.5% to 5%, offset by some reversal in average lending margins since Autumn 2008). This would lead to an increase in household borrowing costs of around £45 billion at today's value. This equates to an extra £1,800 per UK household on annual interest payments alone.

Consumers will find it hard to absorb such large increases in debt interest payments without cutting back on spending. As a result of the fiscal squeeze, there will be pressure to keep interest rates lower for longer, which will delay the point at which this squeeze on spending would take effect, perhaps to sometime beyond 2015. Sooner or later, however, higher borrowing costs will dampen consumer demand.

1.4 Regulation reshapes product design

Section written in conjunction with Hogan Lovells

The tide of regulation continues to rise, with new calls for evidence proposing ever more direct intervention, including the possibility of price caps. Having made significant progress in terms of transparency, we believe the agenda will now focus on fairness, simplicity and consumer understanding. Forward thinking lenders should embrace this agenda and get ahead of the wave (and their competitors) by overhauling their products and business models now.

As regulators and consumers become increasingly wary of what some perceive as the tricks and traps of previous lending practices, we believe fairness and transparency will dominate the debate.

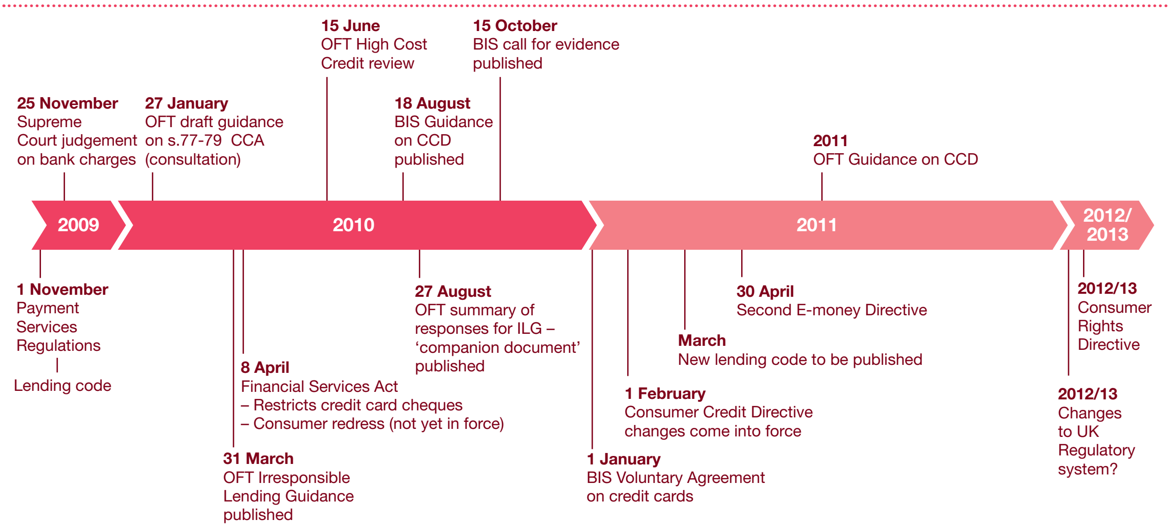
This presents bold industry players with an opportunity to push ahead of competitors and reinvent their offering on a significantly simpler and more transparent basis.

It could have been worse

Recent years have seen an increase in the number of legislative and regulatory developments in the consumer credit market. The timetable in Figure 14 sets these out chronologically, including pending regulatory and legislative activity.

Key developments include the new requirements on explanation, sales practices and cost comparisons ushered in by the BIS voluntary agreement on credit cards (five rights). The main aim is to ensure that customers understand the potential downsides of the products they are taking out. Figure 15 overleaf outlines the main points of the new regulations and their potential implications for lenders.

Figure 14: Timetable of new consumer credit regulation



Source: Hogan Lovells.

Figure 15: Impact of new regulations on the product lifecycle

Product stage	Relevant regulations	Impact on lenders
Product design	**Payment allocation:** From 1 January 2011, monthly payments will have to pay off the most expensive debt first (BIS requirement) **Minimum payments:** From 1 January 2011, minimum payments must cover at least interest, fees and charges, plus 1% of the principal (BIS requirement)	Potentially reduces revenue Will this be a catalyst towards simpler pricing models as the regulators seem to want?
Advertising	**Changes to content:** From 1 February 2011, full representative examples will be required in many more cases and whenever an interest rate is included (CCD).	Lenders are likely to want to include only an incentive and an APR to avoid the need for full information This will be difficult for complex products or offers where the lack of further detail may be misleading. Simpler products will be easier to advertise
Sales process	**Creditworthiness:** Lenders should now assess creditworthiness and affordability as well as ability to repay (CCD/ILG) **Adequate explanations:** From 1 February 2011*, lenders' customer facing staff will need to be able to explain the key product features (CCD/ILG) to a greater degree	Likely to require specialist sales staff and may make it hard to sell where time is limited e.g. at point of sale in retail outlets or at counters in banks Need to consider sales process when designing product features to avoid excessively long or complicated explanations. Simpler products should be easier and quicker to sell Customers may be required to submit information on their applications regarding their income and outgoings
Agreement and copies	**Changes to content:** From 1 February 2011*, new forms of CCA regulated agreement will be required. These give lenders greater flexibility over the form and order of the document (CCD) **Copies:** From 1 February 2011*, the form of pre-contract information will change and will need to be provided in the form of a Standard European Consumer Credit Information (SECCI). In most situations, lenders will be able to provide one less copy of the agreement than they currently provide (CCD)	Systems and process impact. Ability to simplify terms
Variation	**Rate changes:** From 1 January 2011, customers will have 60 days to reject an interest rate increase on their card, close the account and pay down the balance at the existing rate (BIS requirement) **Fairness:** Although there is no new legislation, regulators have been taking an increasing interest in the fairness of variation clauses	Less certainty about lender's ability to vary rates in the future. May lead to an increase in the use of tracker products to avoid termination rights and longer lead-in times before the rate can be introduced. May convert certain products into de facto tracker products because no other changes will be permitted
Termination/ settlement	**New notice requirements:** From 1 February 2011*, two months notice will be required to terminate an agreement with no fixed end date (CCD) **Partial early settlement:** From 1 February 2011*, customers can settle in full at any time (CCD)	Systems impact
Enforcement	**Adequate explanations:** As part of the adequate explanations, from 1 February 2011*, lenders must explain the action they take on default (CCD/ILG)	This could later hinder lenders' ability to change processes or to sell debt to other parties who follow different processes. If action is taken against a customer that was not explained at the outset, the customer could potentially bring a claim that the explanation was inadequate

*Lenders can choose to comply at an earlier date

Source: Hogan Lovells.

Simplicity and transparency

Increased competition and the growth of price comparison websites have put pressure on lenders to maintain low headline rates while recouping income from other, arguably less transparent, sources. Regulators now want to ensure that costs are clearly visible and understood at the outset. For lenders, the main impact of the new regulations will be a push towards simpler products with more transparent pricing. This may result in a move towards a fee driven or 'pay as you go' pricing model, which is common in many parts of continental Europe.

As Figure 15 highlights, while many lenders' revenue is set to come under further pressure the requirements of the industry in the UK are less severe than those in the US, where the industry is still reeling from the introduction of the CARD Act.

It should be borne in mind that simple products are less vulnerable to customer challenge, and potentially would help financial institutions avoid some of the contentious litigation seen in recent years. Customer claims in relation to PPI and bank charges have been very expensive and distracting for lenders. Even if lenders ultimately win the arguments, handling claims ties up a significant amount of management time and is damaging to each individual lender's and the industry's reputation. This climate has also left lenders open to opportunistic claims with little legal, and often no ethical, merit. These outcomes would be reduced, or avoided, with simpler, less vulnerable products.

The response to a move to fee driven pricing of the many consumers used to paying nothing for their card is more open to question. Having potentially been subsidised by people who pay interest they may now need to pay a fixed fee and might therefore decide that using a debit card is a more cost-effective option, meaning lenders may have to enhance the value proposition in order to command a fee.

Potential opportunities

While the continuing programme of regulatory change is for the most part an additional burden for lenders, there are some opportunities emerging from the shake up:

- The harmonisation of consumer credit law across the EU should assist UK lenders that want to expand into other European markets.
- The simplified agreements regime gives lenders the opportunity to develop more straightforward and easier to follow contracts for basic products.
- As a result of the Payment Services Regulations, non-bank lenders who want to become members of main payment systems and/or provide services on a cross-border basis can now register with the FSA as payment institutions, which is both simpler and cheaper than becoming a bank or e-money issuer. This option may be particularly attractive for retailers who decide to fund their store cards themselves, as they would no longer need a partner to provide such cards to their customers.

BIS: Managing borrowing and dealing with debt

The recent BIS call for evidence in support of a consumer credit review shows there is little chance of lenders being left to bed in the recent regulatory changes. Any simplification of the increasingly complex and multi-layered consumer credit regime would be welcomed. However, the call for evidence includes a number of ideas that could cause significant obstacles for lenders including interest rate caps, cooling off periods for store cards and further regulation of overdraft charges, but it shows the appetite for further regulation in this area. Lenders will watch with interest to see which proposals make it through to the consultation paper.

PwC expects to see simpler pricing models, including the widespread introduction of annual fees

Caps on the cards?

As we have discussed, the latest BIS call for evidence includes the consideration of rate caps. The objectives of rate capping and the rationale for singling out credit and store cards from other types of consumer credit are far from clear.

As we discuss later, APRs are a means of cost comparison based on assumptions as to credit usage so using them as the basis for a cap could be potentially problematic. If caps are introduced, they should be focused on interest rates not APRs. Several key revenue lines for card issuers have already been squeezed as a result of regulation and it would seem beneficial to allow the impact of these changes to become clear before introducing rate caps. Indeed, new regulation already gives the customer the power to reject an increase in interest rates, which effectively gives them a personal rate cap.

While rate caps could reduce the cost of borrowing for some, there are a number of potential arguments against rate caps that should be considered:

- **Reduce access to credit:** lenders would be significantly more cautious and this could exclude many customers from credit card products.
- **Migration of interest rates towards the rate cap:** if rate capping was introduced we believe there would be a migration of rates towards the cap and this could increase the cost of borrowing for some customers.
- **Reduced competition and diversity of products:** card issuers may be more cautious to invest in the UK market and could consider leaving the market altogether ultimately resulting in reduced choice.
- **Introduction of, or increase in, ancillary fees and charges:** to offset reduced interest income, we believe issuers would either introduce or increase ancillary fees.
- **Growth in the unregulated market:** as certain customers would be excluded from the credit card market they may be forced to use higher cost lenders and, in the worst cases, unregulated markets.

1.5 A shot in the arm

With bad debt levels beginning to recede and spreads widening the industry has had a much needed short-term shot in the arm. However, as funding costs begin to increase over the next couple of years, the underlying pressures on the business model will become impossible to ignore, leading to more dramatic change in the industry. This could include higher interest rates and much more widespread application of fees.

Widening spreads provide some relief… for now

The credit card business model is on life support in the form of widened spreads and falling bad debts (see Figure 16). For now at least, the widened spreads, generated both by low cost of funds and a simultaneous increases in APRs are sustaining margins. As cost of funds begins to increase this will place pressure on issuers to increase prices.

While lenders enjoy some short-term relief, the underlying challenges with the business model remain (see Figure 17 overleaf). Regulators have restricted many of the issuers' key revenue lines (e.g. payment protection insurance) and are placing further restrictions on issuers' ability to manage portfolios, particularly in relation to re-pricing. In addition, consumers are spending and borrowing less on credit cards thus reducing interchange and interest income. In addition, as funding costs begin to return to more normal levels and margins become squeezed, we expect to see price increases in consumer credit.

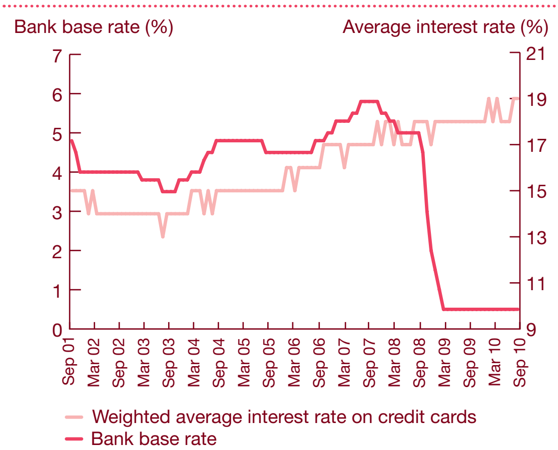
Fee for all?

In parallel to this pressure on the credit card business model, there is an overarching question regarding the fairness of the current pricing model. In the absence of annual fees, those card holders who pay interest could in effect be subsidising those who don't and enabling the latter to hold a credit card for 'free'. With regulation increasingly demanding greater transparency and fairness, we believe this debate will resurface and issuers will come under renewed pressure to reinvent the pricing model on a more equitable basis. With the new regulator's agenda dominated by transparency and fairness, many lenders are likely to overhaul their charging structures, including moving to annual fees.

Price elasticity

With re-pricing of credit cards on the horizon, this year's consumer credit survey included a question asking consumers about their awareness of their interest rate and their likely response to any increase. As Figure 18 overleaf highlights, consumers are largely unaware of the interest rate they pay on their credit cards and don't appear to be especially price sensitive at present, with most pledging to continue to use their card as normal in response to price increases (see Figure 19 overleaf). One of the key questions for lenders is whether the coming price increases might shake consumers out of this apparent apathy and make them more responsive and readier to switch.

Figure 16: Average credit card interest rate versus bank base rate



Source: Bank of England, PwC analysis.

Figure 17: Pressure on the credit card business mode

Drivers	New account volumes	Negative impact on P&L	New account volumes for credit cards have been falling
	Sales volume	Negative impact on P&L	Reduced credit card usage, rise of debit cards
Revenue	Interest income	Negative impact on P&L	Consumers deleveraging and paying less interest
	Default Fees	Negative impact on P&L	Late fees effectively capped
	PPI insurance	Negative impact on P&L	Sale of PPI restricted
	Interchange income	Possible future negative impact on P&L	Long term prognosis for interchange unclear
Costs	Acquisition costs	Negative impact on P&L	Regulation driving up acquisition costs
	Cost of funds	Positive impact on P&L	Funding cost relatively low… for now
	Loyalty costs	Negative impact on P&L	Loyalty programmes not devalued despite all pressures
	Operating expense	Negative impact on P&L	Operating expenses not being sufficiently reduced
	Bad debt	Negative impact on P&L	Bad debts at record highs

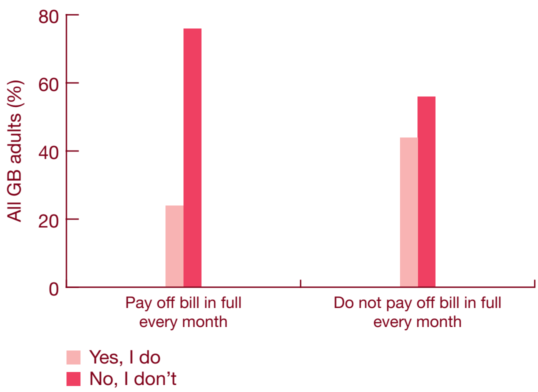
Negative impact on P&L

Possible future negative impact on P&L

Positive impact on P&L

Source: PwC analysis.

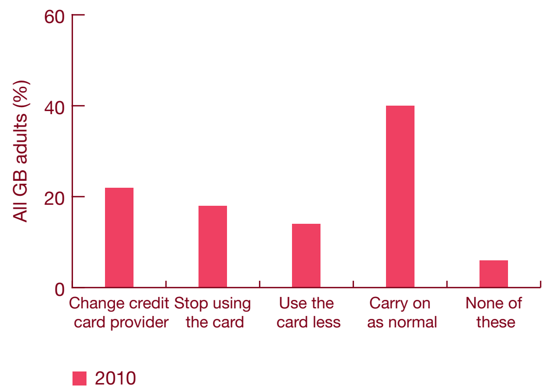
Figure 18: Are you aware of your interest rate?



Note: Only answered by those who own credit cards, YouGov

Source: PwC Credit Confidence survey 2010.

Figure 19: Response to credit card price increase



Note: Only answered by those who own credit cards, YouGov

Source: PwC Credit Confidence survey 2010.

The percentage of consumers who would carry on as normal in response to a credit card price increase

40%

Fresh impetus to an old debate: APRs

The expected re-pricing in the industry and more widespread introduction of annual fees coupled with a trend towards shorter term, smaller ticket lending is set to reignite the debate over the relevance of annual percentage rate (APR) as a measure of the cost of credit. Detractors have long argued that consumers don't understand APRs and that they are a flawed and over complicated means of comparing and understanding the cost of borrowing across different products, particularly for shorter term borrowing and revolving credit.

The Consumer Credit Directive is coming into force by early 2011 and seeks to promote further the standardisation and clarity of credit advertising. The CCD continues to require an APR to be used. While the APR is intended to provide a standardised measure of the cost of credit that is stipulated on all offerings and can be readily compared across products, in reality consumers do not understand what APR actually means. It is the equivalent of giving someone the technical specifications of a car engine when what they really want to know is how many miles they are going to get to the gallon. The cost of credit needs simpler explanation for consumers.

APR is an annual measure and includes both repayments of principal and interest and charges in its calculation. It is arguable that the APR calculation does not accurately reflect the manner in which credit cards are used, therefore failing to accurately impart to a consumer what they will actually end up paying.

APRs and short-term borrowing

Payday lenders and other shorter term, small ticket loan providers have come under considerable media scrutiny. As increasing numbers of consumers find themselves unable to access credit from traditional sources, more and more consumers are using payday loans featuring APRs sometimes in excess of 9000%. The astronomical figures quoted have led to regulatory action in the US where a number of states have placed caps on APRs and effectively closed this market.

In the case of payday lending an APR is fundamentally misleading. Annualising the interest cost of a product that is only offered as a short-term facility confuses the purpose of the loan and misrepresents the true cost. It's similar to suggesting that the typical annual cost of a rental car might be close to £15,000, rather than a daily rate of £40. The total charge for credit may be a more beneficial measure for the consumer in this instance.

Part 2: What next?

2.1 Supply, demand and the cost of credit

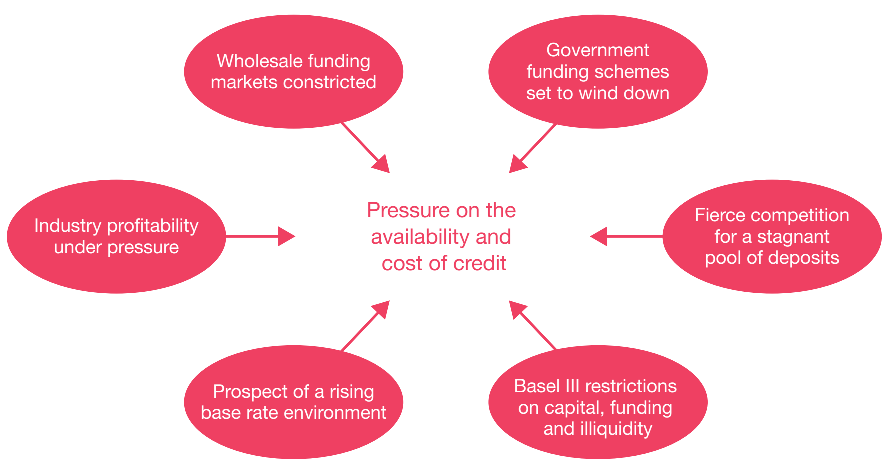
A number of factors are combining to restrict the availability of credit. We expect the overall availability of credit to contract and anticipate an increase in its cost. The impact will vary by product and by customer segment. Unsecured lending will be hardest hit, particularly among higher risk customer segments.

Supply to remain constrained

Among the key factors that are set to restrict the supply of credit (see Figure 20), are new rules on capital, funding and liquidity. In September 2010, the Basel Committee announced new global standards for the levels and quality of capital that banks will be obliged to hold ('Basel III'). In addition, the Basel Committee will introduce new leverage and liquidity requirements. These radical changes have been ratified by the G20, together with a timeframe for the transition towards a tougher definition of capital.

The new regime requires that banks hold a minimum of 4.5% core tier 1 capital by 2015. On top of this, banks will need to hold a further 2.5% capital conservation buffer,[4] establishing a hard minimum of 7% and a de facto minimum of well above this level. Following a significant round of capital raising in 2009, UK banks are well capitalised by Basel II standards (see Figure 21). Compliance for some continental European institutions will be tougher and we expect to see banks raising further capital. This could potentially provide UK institutions with an advantage.

Figure 20: Pressure on the availability and cost of credit



Source: PwC analysis.

4 Banks that do not hold a sufficient buffer will have to agree a plan to restore capital levels through restrictions on dividends and potential deleveraging.

While Basel III provides the framework that banks will have to follow, local territories may also impose their own additional requirements. Regulators in the US, UK and Switzerland have been proponents of higher levels of capital than those agreed, particularly in relation to those banks that are regarded as being systemically important. In the UK, the precise form of any additional measures is not certain and discussions continue in relation to the need for additional buffers and the application of stress buffers under the existing Pillar II arrangements.

In our view, the relatively strong current position of the UK banks should allow them to make the move to the higher levels of capital over the transition timeframe without looking to the equity markets to bolster their balance sheets. However, some banks will choose to raise capital to allow them to meet requirements early believing that this will give them a strategic advantage.

The new liquidity standards present a further challenge to the banks. Basel III calls for the establishment of a liquidity coverage ratio (from 2014) and a net stable funding ratio (from 2018). The deferral in the implementation of such standards will give the banks a breathing space as they refinance their balance sheets. The large UK banks need to refinance some £440 billion of maturing debt before the end of 2012. This requirement is greater than France, Germany or even the US (see Figure 22). Over the same period, the UK government is likely to start winding back special funding arrangements (e.g. the Special Liquidity Scheme), which were introduced during the financial crisis. The unwinding of such measures could increase the refinancing hurdle over this period to around £750 billion.

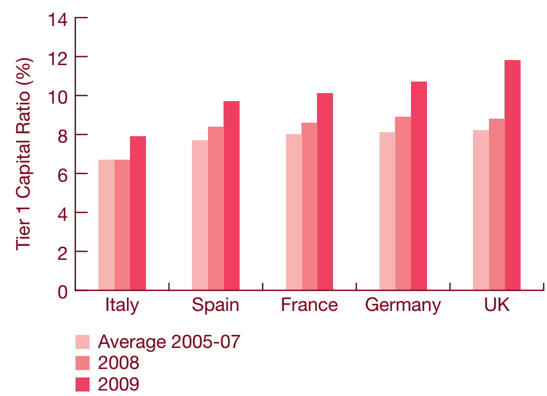
If the market were left to finance this requirement in its entirety, a greater level of new debt funding than was seen even at the pre-crisis peak would be required. In due course, the Government will crystallise its plans in relation to the special funding measures. If it follows a similar path to that taken by the European Central Bank, where 12 month debt financing has been replaced with a more expensive three month rolling facility, lenders would be forced to either reduce their funding requirement by deleveraging further (reducing the availability of credit and/or selling portfolios) and/or increasing the cost of credit to compensate for their increased funding capital allocation and funding costs.

In the extreme scenario where the Government pulls back its support mechanisms entirely, it's unlikely that the market could cover the full refinancing requirement, so forcing lenders to dramatically shrink their balance sheets and/or dispose of illiquid asset portfolios to reduce their funding requirement.

These funding constraints are exacerbated by static deposit levels and continuing constriction in the wholesale funding markets. The liquidity reforms will require banks to hold a greater proportion of their assets in more liquid (thus lower returning) asset classes such as government gilts or even cash.

To restore returns to acceptable levels banks will have to compensate for the higher capital charges and increased funding costs resulting from implementation of Basel III.

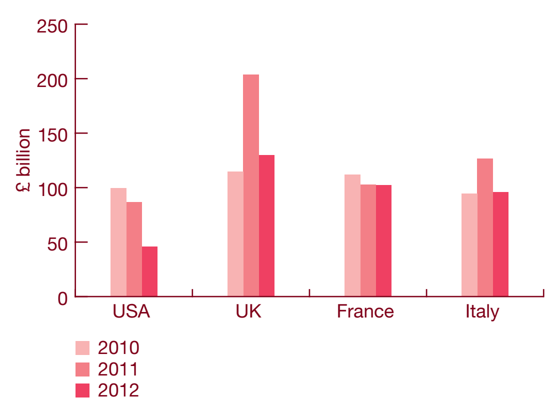
Figure 21: Tier 1 capital ratios for selected European banking systems (a) (b)



(a) Includes banks with total assets of more than US$100 billion.
(b) Aggregated from individual banks, weighted by total assets.

Source: Capital IQ, Moody's Investors Service, published accounts and BoE calculations.

Figure 22: International bank refinancing requirements (a)



(a) Calculated as a percentage of average issuance between 2005 and 2007. Only senior unsecured debt, subordinated debt, covered bonds, RMBS (public and retained) and official sector support (government-guaranteed debt issuance and asset swap facilities) have been included in the calculations. RMBS issued in the United States and EU have been assumed to mature, on average around four and five years respectively, following origination. Only issuance to end-2009 is included in calculations.

Source: Bank of England, Dealogic, ECB, FDIC, Fitch, SoFFin, UK DMO and BoE calculations.

The proportion of consumers less willing to consider borrowing to fund large purchases assuming the current economic recovery continues

53%

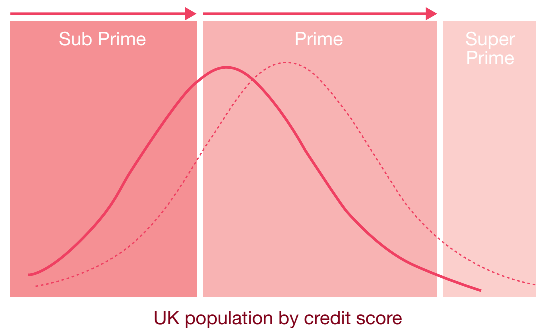
The rise of the underbanked

With the supply of credit constrained, lenders will continue to be selective about who they lend to, effectively re-drawing the boundaries of what constitutes prime and sub-prime (see Figure 23). At the same time, we believe that credit scores across the UK population have deteriorated as consumers have struggled to cope with the challenging economic conditions; there will be a large number of consumers who will have damaged their credit score as a result of missed payments over the last couple of years. Consequently consumers are faced with a double effect: lenders being more selective and the possibility that their credit score has deteriorated.

Lenders will target their scarce capital with increasing precision at only the most profitable customer segments. A key challenge for lenders will be distinguishing between those customers who are fundamentally 'good risks' but may have inadvertently missed a few payments and those that are likely to experience continuing problems. For customers who fall into a target segment for lenders, credit offers will be highly attractive as lenders compete for their custom. For those outside of this target segment a surprisingly large number of consumers will effectively be excluded from accessing credit from mainstream lenders leading to a rise in the underbanked population. If the recovery continues to gain ground and demand for credit begins to trickle back, this mismatch between supply and demand will come to the fore, though a rise in demand is less certain in the wake of the Spending Review (see Figure 24).

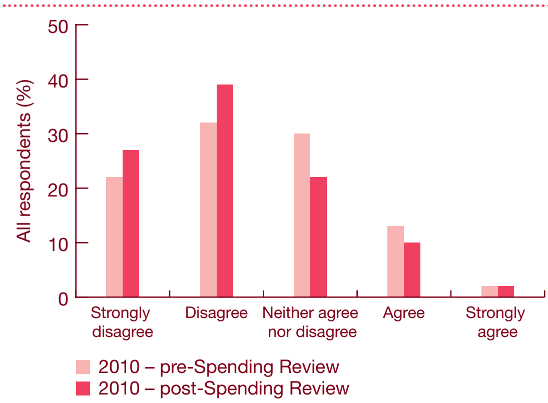
A significant proportion (22%) of consumers are concerned about the availability of credit in the future (see Figure 25). Others may find themselves facing a personal credit crunch as reduced supply makes it much harder to secure a loan. The potential exclusion of so many customers will open up significant opportunities for non-traditional lenders to enter the market or strengthen their presence. It's also bound to trigger industry and public debate (similar to that currently surrounding SME lending) about how underbanked consumers should be serviced. This debate will raise important questions about the social purpose of lenders and the risk that more people will be forced into higher interest rate borrowing.

Figure 23: Illustrative shift in UK credit score and lender cut-offs



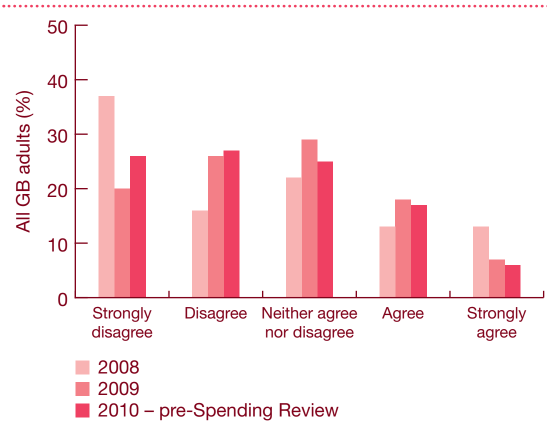
Source: PwC analysis.

Figure 24: Assuming this current economic recovery continues, I will be more willing to consider borrowing to fund any large purchases I am planning



Source: PwC Credit Confidence survey.

Figure 25: I am worried about the availability of credit for future purchases



Source: PwC Credit Confidence survey.

2.2 From top line to bottom line

Many lenders are adapting well to the new reality of operating in a contracting market. Other institutions are finding it more difficult to change as they seek to transform an operating model still geared to doing business in a growth market. As the market contracts, the emphasis has shifted from top line growth to a closer focus on growing the bottom line. This requires more effective cost control, cross-selling, product rationalisation, maximising collections and debt sale opportunities and unlocking value from existing customers.

New tool kit for a contracting market

The 'old tool kit' developed during the growth years focused on new product launches, customer acquisition and aggressive pricing to build market share (see Figure 26). The 'new tool kit' will be much more precisely targeted in its approach to segmentation, customer value and operational efficiency as it seeks to maximise margins and grow the bottom line ('from ubiquity to precision').

Figure 26: Moving from the old to the new tool kit

Old tool kit 'Top line focus'	New tool kit 'Bottom line focus'
New customer acquisition and balance sheet growth	Unlocking value from existing customers
Aggressive pricing to acquire market share	Dynamic pricing to maximise margin
Product value management	Customer value management
Cross subsidised products	Transparent products
Investing in products and partnerships	Strategic cost reduction

Source: PwC analysis.

Product rationalisation

Through the growth years we saw a surge in new product launches as lenders sought to increase market share. This proliferation has inevitably heightened operational costs and the complexity of portfolio management. As lenders look to control costs and simplify management, now may be the time to step back and rationalise the product suite. The foundation is analysis of which products customers value most and the relative returns that are being generated. There will be a tendency towards fewer products, alongside greater emphasis on flexing pricing strategies and features by customer segment.

Strategic cost reduction

While some industries such as retailing have a close understanding of their cost base across the entire value chain, this has rarely been the case in financial services. The cost of servicing products has been opaque and not widely understood. In the past, rapidly rising revenues tended to generate favourable cost-income ratios even if underlying costs were relatively high. As lenders look to drive down cost, product P&L owners will need to develop a line by line understanding of the full costs of delivery and work more closely with their partners in operations and IT to engineer savings. In addition to running existing processes more cheaply, many lenders will look to simplify and/or pare back product features and services.

Smarter collections

Maximising collections will be crucial in sustaining liquidity and returns, although current approaches are recouping far less than is possible. Debt management processes are often reactive rather than seeking to analyse, anticipate and move early to tackle debt problems before they escalate. This is often compounded by lack of sufficient engagement with debtors and ineffective performance management that fails to target resources efficiently. Recovery processes have also become more complex as a result of new consumer debt restructuring options and the need for care and sensitivity to avoid potential reputational damage.

A more proactive and effective approach to debt management would seek to detect signs of debtor difficulty earlier than is generally the case today and work with customers to understand their financial position and put sustainable plans in place.

The key to success is likely to be a more customer-centric approach. The main aim is to build a rapport with customers who are having problems to encourage them to maintain contact with the creditor institution and ensure that this particular debt remains a priority amid what may be a number of unpaid bills. Indications from the US suggest that better engagement can help to improve recovery rates.

Banks may also seek greater engagement to help sustain a customer relationship that may have been profitable before and might continue to be so in the future once any temporary difficulties are overcome. For instance, the debtor may have run into problems after losing their job, but will be able to address them and offer renewed value to the bank once they're back in employment.

Investment in data management and analytics can help lenders to profile customers more effectively and develop better early warnings systems. Improved information systems can also help banks to develop more effective recovery metrics that will enable them to target their resources at debts with the greatest probability of repayment and align their recovery KPIs with the overall strategic priorities of the institution.

Outsourcing to specialist agencies can be valuable. Clear vendor scorecards and management processes will help to ensure that collection is aligned with the bank's targets and policies, as well as the level of control it wishes to retain over the customer relationship.

Realising value through debt sales

With UK financial institutions facing refinancing demands of more than £750 billion (see page 21), they'll need to find ways of turning existing illiquid assets (including loan portfolios) into liquid assets to help fund refinancing and manage their liquidity profile. Figure 27 highlights the recent increase in non-performing loan (NPL) portfolios and these portfolios offer the potential to realise cash.

Option 1 – accelerate payments on illiquid assets

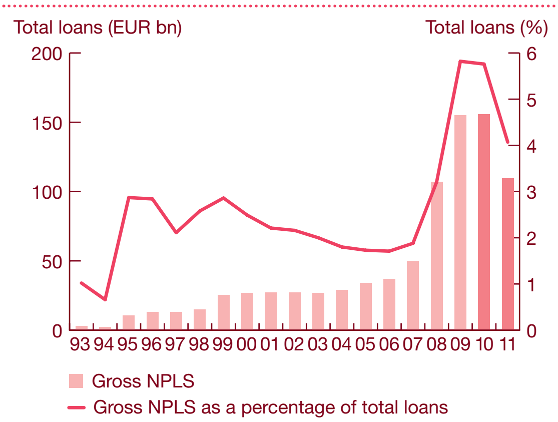
Some financial institutions have sought to accelerate cash flows from illiquid financial assets by offering discounts and/or waiving prepayment penalty fees to encourage borrowers to refinance elsewhere. While such approaches may be feasible and attractive for the highest quality borrowers, institutions may take some time to see the liquidity benefits. For a large number of borrowers, alternative funding at an attractive interest rate may not be available.

Option 2 – disposal programme to generate cash

While Option 1 will help, it can only go so far in realising the necessary funds. We would therefore expect banks to supplement such approaches with more direct action such as loan portfolio sales. The particular type of loan portfolios that are likely to be attractive to sellers will vary across different institutions. Selling at a price below net book value comes into conflict with profit and loss objectives, though may become necessary in order to manage the liquidity profile. The primary focus in the short-term is therefore likely to be portfolios that are heavily provided for or fully written off as such sales would have a less detrimental impact on the P&L.

For non-performing or non-core loans with higher values, it's likely that a discount to net book value would occur given current investor hurdle rates, although there are potential structuring solutions that seek to mitigate the profit and loss impact on any difference between sales price and net book value. Such sales are also likely to generate greater liquidity because there's relatively higher economic value associated with these assets e.g. secured loan portfolios. As many banks look to concentrate on their

Figure 27: Estimated UK gross bank NPLs and NPLs as a percentage of total loans



Source: Broker reports, financial statements, PwC analysis.

Total UK non-performing loans

£130 billion

home markets, we expect to see a greater number of loan portfolio sales to come from foreign based banks in the UK looking to exit or run-down their overseas operations.

Figure 28 provides an illustrative view of where we believe debt sales will happen in the UK market in the next 12 months, highlighting the likelihood of opportunities coming to market in the next year and the degree of competition for those asset classes. Some key trends we expect to see include:

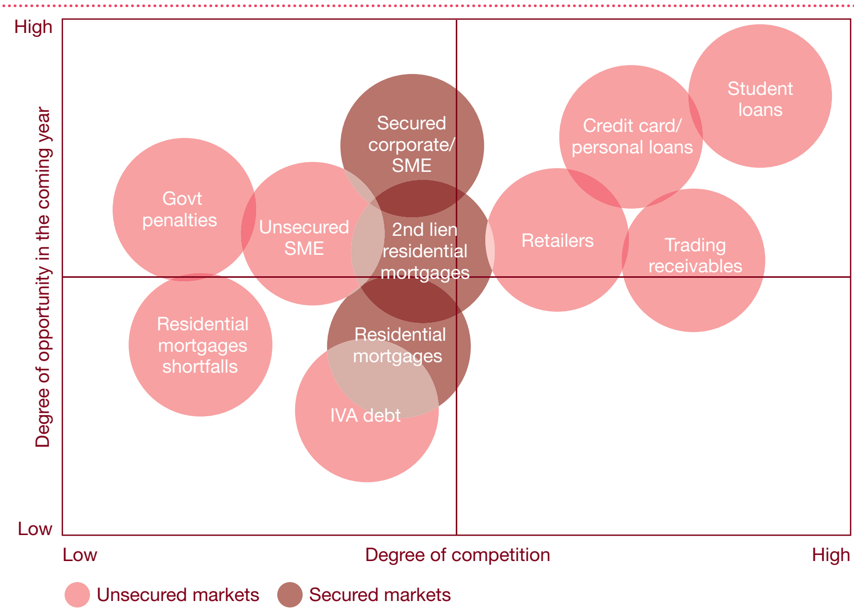
Student loan debt: The potential sale of the Government's student loan book in England will be a significant transaction, with large institutional investors looking at this as an important new asset class.

Unsecured distressed debt: The market is relatively mature compared to other asset classes. Prices dropped significantly in the wake of the financial crisis and therefore many financial institutions have invested in collections and recoveries. However, there is still a backlog of stock, which is likely to be sold in the coming year. This will attract both traditional and new entrants into the UK distressed debt market.

Residential mortgages: The market is huge in the UK with the sale of performing and non-performing mortgage portfolios a likely source of liquidity. There are a number of buyers lined up with capital to target such asset classes. One of the issues facing buyers and sellers alike is how the assets are serviced through transitional servicing arrangements and who takes over responsibility in the longer term. Therefore while competition will be strong in this area, failure to have an executable servicing plan in place will hinder some entrants into this market.

High loan to value (LTV) mortgages: High LTV mortgages were offered at the height of the property boom. As a result, even after repossessions there may still be a shortfall owed by the customer, which is effectively an unsecured debt. So far there have been few moves to sell this debt, though as it's likely to have limited, if not zero, book value this could provide a source of liquidity without an adverse P&L effect and one where the market for buyers is less competitive.

Figure 28: Debt sale opportunities



Source: PwC analysis.

2.3 Smaller loans, shorter terms

Contraction in the availability of mainstream credit will create a range of market openings.

The second coming for point of sale credit?

Following years of shrinking volumes, high levels of bad debt and intense regulatory scrutiny, many felt that the introduction of the Consumer Credit Directive could be the final nail in the coffin for retail point of sale finance (store cards and sales finance). However, with many consumers finding it harder to secure credit from mainstream lenders and seeking to borrow on a more cautious basis, we predict that there will be rising demand from customers for simple, contained point of sale finance products and increasing returns for those specialist providers left in the market.

While operating point of sale credit will become more challenging following the introduction of the CCD, most lenders feel increasingly confident that enhanced sales processes and staff training can cope with the additional regulatory requirements. We expect to see a greater use of technology in the application process and a smaller group of more specialist staff selling point of sale finance. For the industry, this change in the sale process could have the positive effect of improving the quality of applicants as it's likely to weed out those less committed applicants who only intended to take financing arrangements to secure an initial discount on their retail purchases.

However, further uncertainty lies ahead with the latest BIS call for evidence (managing borrowing and dealing with debt) examining the possibility of interest rate caps and cooling off periods between customers being sold credit and actually being able to use it. However, with large numbers of consumers unable to access credit from mainstream lenders, we believe that point of sale credit will become an increasingly important product.

Having historically viewed financial services and point of sale credit as a profit centre in its own right, retailers are now more focused on the role point of sale credit plays in driving retail sales and the customer insight it can generate. This rebalancing of retailers' objectives will improve returns for providers and may make the industry attractive to new entrants.

Small ticket, shorter term lending

As the underbanked population has increased, so too has the market for smaller ticket, short-term credit. Consumers unable to access credit from mainstream lenders are increasingly turning to the likes of payday loans, home credit providers and pawnbrokers. Research estimates indicate that total UK payday lending in 2009 stood at over £1.2 billion, more than three and a half times the 2006 level.[5]

However, this rapid growth has not been driven purely by the increase in the underbanked population. While some consumers have been disenfranchised, others have opted for alternative financial service providers out of choice, eschewing the open ended revolving credit arrangements and overdrafts from banks and building societies in favour of quick and convenient access to short-term 'jam jar' credit of limited amounts and terms. According to an Office of Fair Trading (OFT) survey, 43% of high-cost credit consumers 'said that speed of arrangement was a reason they chose their credit product',[6] a more important factor than both low interest rates and affordable repayments.

5 Keeping the plates spinning, Perceptions of payday loans in Great Britain, published by *Consumer Focus* in August 2010.

6 Review of High-cost credit, published by the *Office of Fair Trading* in June 2010.

In the US, certain States have capped APRs, effectively making it impossible for payday lenders to operate. The OFT have advised against such action in the UK, instead proposing better education of consumers to enable them to make more informed judgements with regard to credit applications and the promotion of best practice amongst the suppliers of short-term credit. It is a valuable product for a growing number of consumers who would be left in a vulnerable position by any actions that decrease competition in the sector.

The media backlash against payday lenders is largely as a result of the high APRs publicly quoted. We have discussed the inappropriateness of the APR measure for such lending on page 19. In addition to displaying an APR, many payday lenders present the pricing of their products as the actual pounds sterling cost of borrowing, and through this simplification could be ahead of their mainstream rivals in improving understanding of the costs involved. Mainstream lenders are unlikely to have a cost base that is conducive to providing small ticket short-term loans.

The continued success of this business model will be heavily influenced by both the state of the UK economy and regulation. Whatever this sector's future, there are potentially lessons to be learned by larger financial institutions from its proliferation.

Market shake-up creates openings for innovation

While many lenders are focusing on how to adapt to a contracting market and embedding the new tool kit (Figure 26), the shake-up in the market is set to create openings for innovation. Smart organisations will be looking closely at how to capitalise on these developments and how to target investment most effectively.

Many organisations are striving to identify new sources of income to make up for the anticipated loss of traditional revenue streams. In addition, lenders can leverage their existing infrastructure and/or develop partnerships with other organisations that have been able to demonstrate the technical and commercial viability of innovative new concepts.

For some banks and other traditional lenders, innovation will be an imperative as they seek to keep pace and differentiate themselves from non-traditional competitors. For example, some banks and credit card issuers, particularly in North America, are exploring the opportunities opened up by online or mobile person-to-person (P2P) payments. While P2P fund transfer providers have been operating successfully for almost a decade, non-bank institutions such as retailers and social networking organisations are looking for opportunities to exploit their sizeable customer base and commercialise P2P.

The P2P payments market has recently seen considerable interest from US lenders. Primarily driven by the existing growth of online transactions and the potential for wider adoption of mobile payments, US banks foresee a revenue opportunity associated with facilitating P2P money transfers for both domestic payments and international transfers or remittances.

In most instances, lenders have sought to move into the market by forming strategic alliances with third party P2P solution providers. Most of these providers have been able to demonstrate the technical and commercial viability of their P2P solution, prior to partnering with banks in the US. A few large US lenders have chosen to address the P2P payments opportunity by developing proprietary solutions.

Along with retail payments, P2P offers opportunities for small and mid-size business customers. Leading US banks have tied up with third-party providers of P2P payment solutions, which provide businesses with the unique capability to pay vendors and employees electronically using an email or mobile number.

Similarly, credit card issuers can leverage existing capabilities and merchant relationships to pursue innovations in online micropayments and prepaid card products, which may provide fresh revenue opportunities as consumers look to deleverage following the recession.

Research estimates indicate that total UK payday lending in 2009 stood at over

£1.2 billion

Conclusions

The consumer credit market is being sustained by temporarily wide spreads. Once interest rates go back up again and the constraints on funding mount, the supply of credit is going to diminish and it is going to be much harder for lenders to make a decent return. What will mark out the winners from the losers in a market where margins are under an ever tighter squeeze and growth is no longer a given?

Consumer credit is no longer a growth sector and any recovery in demand is set to be tentative at best. Looking to the long-term, our macroeconomic analysis sees little chance of a return to the expansion seen in the years leading up to the financial crisis.

New consumer protection regulation should trigger a move to simpler and more transparently priced products. At the same time, consumers' attitudes have begun to change. The 'buy now pay later ethic' founded in the seeming certainty of future rises in income and property prices is giving way to a much more circumspect attitude to personal finance, especially among the younger generation. Their greater propensity to save will help one side of the banking balance sheet, but it will make it much harder for banks and retail businesses to sustain expansion and is certain to heighten competition within these sectors.

The 'pile it high and sell it cheap' model of consumer credit, in which attracting more customers was the key driver of growth, will therefore have to give way to a more cost-conscious bottom line focus. Sharper customer targeting, more proactive and engaged debt management, and greater emphasis on debt sale opportunities will all be crucial as lenders seek to sustain liquidity and returns.

There will be opportunities for some. Forward thinking banks are already looking at how to drive down costs, enhance customer profiling and bring in people with the skills and motivation to meet today's tougher demands. Such institutions will be better able to target profitable segments and beat their rivals on cost and service. For others there will be challenges. Changing from a top line to a bottom line focus and bringing in the people, systems and underlying culture this demands will impose new and unfamiliar expectations on many larger institutions. The urgency of transition will be heightened by competition from nimble new entrants unencumbered by high operating costs and a legacy of debt with the potential for more trusted brands.

The definitions of prime and sub-prime are already shifting, leaving many more people with no effective access to mainstream lending. This will extend the debate over the social role of banks and there may be pressure to continue to provide credit as the payback for Government support during the financial crisis. Many more people will turn to short-term alternative lending. Robust consumer protection will clearly be essential. But it will also be important to communicate cost measures that provide borrowers with a meaningful way to judge and compare prices, as well as using the required APR metrics designed for longer term lending.

A new and more sustainable profitable business model should emerge from these developments. We believe key attributes for success will be:

- Identifying key competitive differentiators and matching these to profitable target segments.
- Product P&L owners taking direct responsibility for understanding and managing the cost of delivery to ensure competitive pricing in key target segments.
- Rationalisation of products for the mass market, supported by carefully differentiated products for key target segments.
- Proactive and customer-centric approach to debt management, underpinned by effective profiling, early warning systems and recovery KPIs.
- Maximising liquidity by making the most of opportunities for debt sales.
- The people and culture needed to understand and manage the drivers of bottom line return in a stagnant market and identify profitable new opportunities.

About PwC

The consumer credit market is undergoing a period of change, demanding participants to be more competitive and innovative. The Consumer Finance team of PwC is a leading adviser in this 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:

- Strategy and business plans
- Market and economic analyses
- Partnership strategies and contract negotiations
- Debt portfolio strategies
- Valuations
- Regulation and the business response
- Due diligence
- Transaction and investment decisions

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