PRICEWATERHOUSECOOPERS

Precious Plastic 2007

Consumer credit in the UK

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Introduction

This sixth annual edition of PricewaterhouseCoopers (PwC) Precious Plastic report covers the UK consumer credit market. We have expanded this year's edition to consider the UK market in comparison with the US and other major European markets. In addition, in view of the growing concern surrounding the personal insolvency market, we consider the likely future trends of this market.

Key highlights include:

- After many years of rapid expansion, growth in the consumer credit market is finally decelerating. Profitability is under increasing pressure from a combination of significantly higher bad debts and the impact of regulatory actions.
- There has been continued media attention highlighting the problems of over-indebtedness, reflecting the sharp increase in personal insolvencies which are expected to exceed 100,000 this year.
- The credit card industry is under intense regulatory scrutiny. PwC estimates that the recent ruling on default fees, combined with the potential impact of current investigations into interchange fees and payment protection insurance (PPI), could cost the industry £1 billion per annum.
- A comparison with international markets finds that UK consumers are teetering under relatively more unsecured debt than Americans, and have by far the highest borrowings in Europe.

Section 1

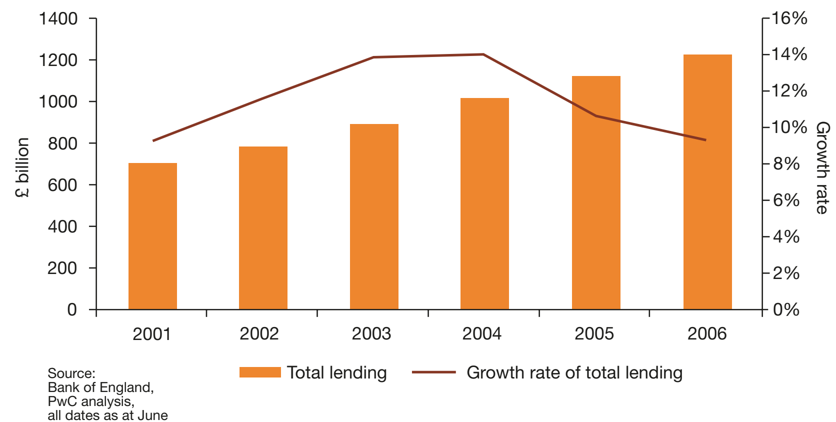
What's happening in the consumer credit market?

Total lending continues to increase

Only two years ago, headlines were made when the total level of indebtedness of the UK population reached £1 trillion. Despite ongoing concerns, total household borrowing has continued to increase, reaching a total of £1.2 trillion by the end of June 2006. This represents a 9% increase over the previous year. Secured lending (i.e. mortgages) alone now totals more than £1 trillion, having grown by 10% for the second year in succession.

However, over the past couple of years the overall rate of growth has been declining, recently due to a slowdown in unsecured lending growth (i.e. credit and store cards, personal loans and overdrafts) from 9% in 2005 to just over 2% in 2006.

Figure 1.1 Total lending and growth rate

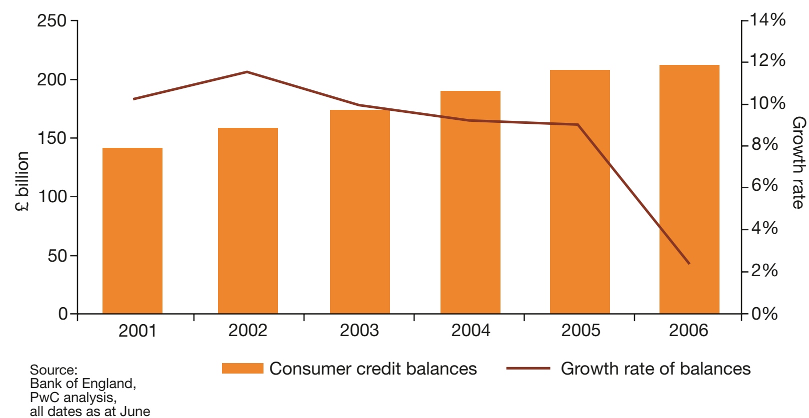


Growth in consumer credit balances is clearly stalling

Last year PwC predicted a significant slowdown in growth rates of consumer credit balances, and they are now following a very different trend to the five previous years, as shown in figure 1.2 below. Between 2000 and 2005 the average annual growth rate was 10%, and it never fell below 9% in any year. However, in the 12 months to June 2006 there was a significant slowdown, with consumer credit balances growing by only 2.4%. Have we now reached a natural ceiling for consumer credit balances?

Extensive media coverage highlighting the problems of over-indebtedness appears to be influencing consumers' willingness to increase borrowings. Increased bad debts have also made lenders more cautious. Interest rates were stable at 4.5% in the 12 months to August 2006 and perhaps the recent rise to 4.75%, with the prospect of further increases in the short term, will encourage more consumers to save rather than spend. Further rate rises would add pressure to debt commitments and would no doubt discourage more consumers from taking on further obligations.

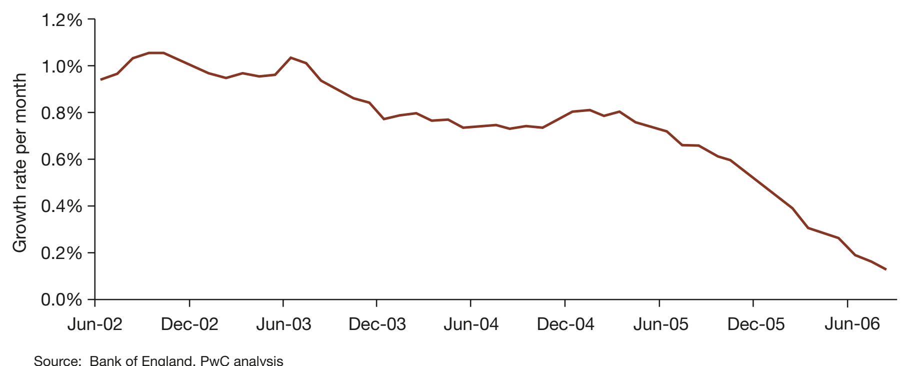
Figure 1.2 Consumer credit balances and growth rate



Source:
Bank of England,
PwC analysis,
all dates as at June

Figure 1.3 shows monthly growth rates for consumer credit balances on a 12-month rolling average basis. This graph clearly shows the significant slowdown since June 2005. The 12-month rolling growth rate in June 2005 was 0.72%. By August 2006, this had fallen to just 0.13%.

Figure 1.3 Consumer credit outstanding balances (12-month rolling average)



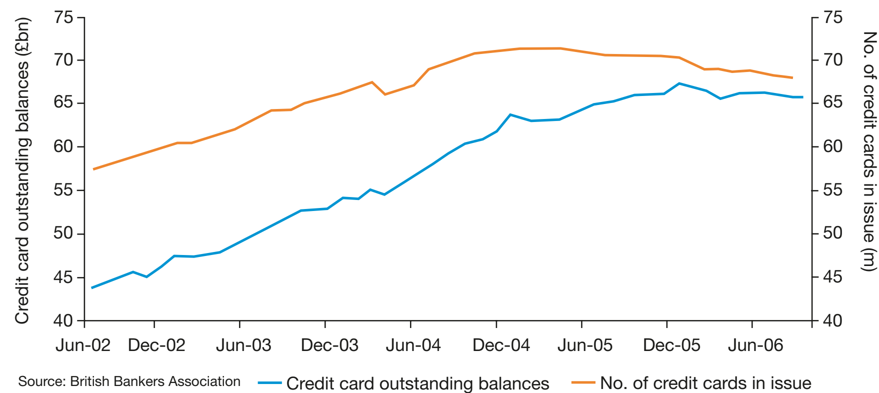
Source: Bank of England, PwC analysis

Lower or static balances will put increased pressure on margins

Credit card outstanding balances have, unsurprisingly, followed a similar trend to the overall consumer credit market. During July and August 2006, outstanding balances actually fell to just under £66 billion. While this was a drop of only £0.4 billion compared to June 2006, it appears to signal the end of an era where issuers could count on ever-increasing balances.

During the last year the number of credit cards in issue has decreased, falling from around 71 million in June 2005 to just over 68 million by August 2006. New credit cards brought onto the market will therefore have to seize market share to succeed rather than simply participate in general market growth. PwC therefore expect there to be an increasing focus on the retention of existing customers.

Figure 1.4 Credit card outstanding balances and cards in issue



Source: British Bankers Association

The reduction in the number of cards in issue is being driven by a number of factors:

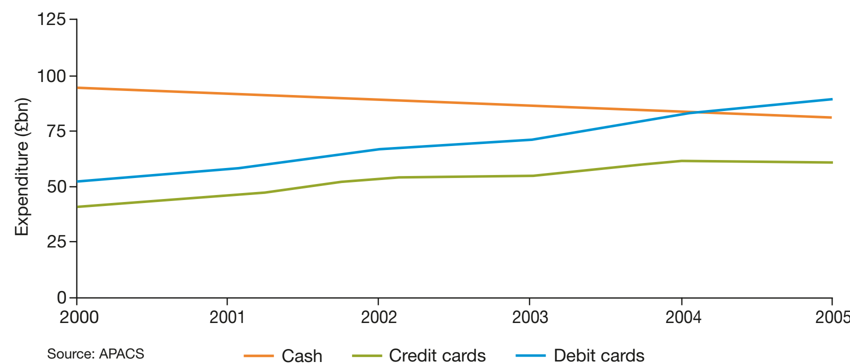
1. The introduction of "Chip and PIN" encourages both issuers and consumers to rationalise cards. Despite functionality that allows consumers to change PINs there appears to be customer inertia, hence fewer cards in the wallet limits the need to remember different PINs.
2. The growing application of balance transfer fees on introductory offers has reduced switching between cards and hence new card applications.
3. There is anecdotal evidence of a reduction in acceptance rates which is also likely to be having an impact.

If outstanding balances remain broadly static, the market will become increasingly competitive as providers battle for "share of wallet". This increased competition will in turn put additional pressure on issuers' profit margins. Institutions will therefore take a harder look at their cost base, with international operators looking to achieve further globalisation as they seek economies of scale.

Debit card spending in the high street overtakes cash

In 2005, spending on debit cards exceeded cash expenditure in the high street for the first time, increasing by £7 billion to £89 billion, as shown in figure 1.5. Cash payments fell from £84 billion in 2004 to £81 billion in 2005, proving that debit cards are the preferred payment method of many shoppers. In 2005, credit and debit cards accounted for 65% of total retail sales, up from 49% in 2000. This growth was largely driven by the increase in debit card spend.

Figure 1.5 Spending in the high street



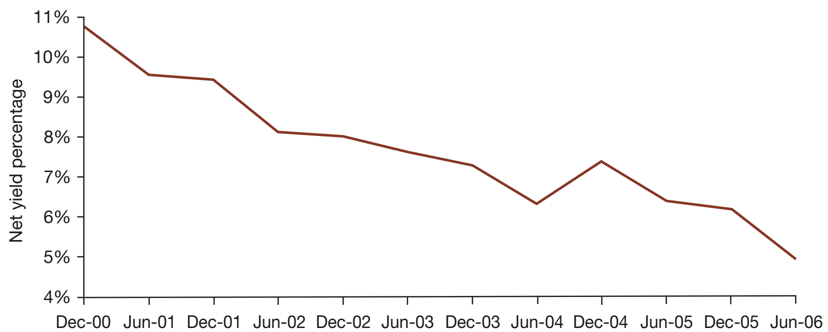
Source: APACS

Credit card profitability continues to fall

Figure 1.6 shows PwC's estimate of average net interest yield across the credit card market after deduction for charge-offs. This analysis shows a continuation of the well-established downward trend. Net yield fell from around 6.5% in June 2005 to just under 5% by June 2006.

Between 2000 and 2005, the reduction in yield was largely attributable to reductions in interest rates charged to consumers. However, in the 12 months to June 2006 this trend has reversed, with average interest rates increasing by around one percentage point as issuers responded to increasing bad debts and the impact of actual (and expected future) regulation. But a bigger-than-expected increase in bad debts means they have still been unable to maintain net yield, despite the rise in rates. Consequently, margins across the industry have continued to decline, indicating that the trend of increasing interest rates is likely to continue.

Figure 1.6 Net interest yield after charge-offs

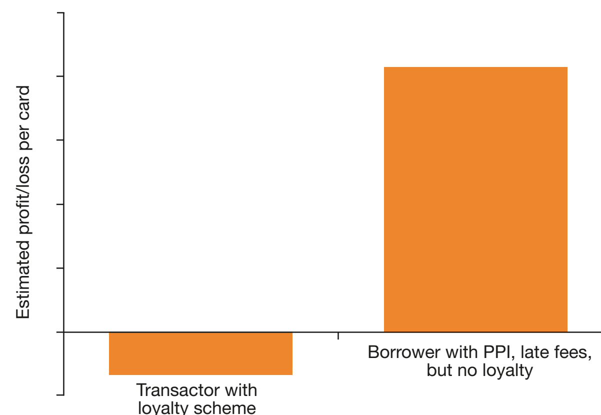


Source: Standard & Poor's, Bank of England, PwC analysis
Note: The Bank of England has restated their figures, which has changed the calculation from last year

Profitability of different cardholders

There are significant differences in the profitability of different groups of cardholders. Those with a loyalty scheme and who pay off their balance on time and therefore incur no interest charges are likely loss-makers for the card issuer. It should be borne in mind that in 2005, 59% of all cardholders paid off their balance in full each month. In contrast, a borrower who also takes out PPI and does not make use of a loyalty scheme is likely to be highly profitable. The challenge for issuers is to attract borrowers. Balance transfer offers - which have bred a group of consumers, the so-called "rate tarts" - has been one means of doing so.

Figure 1.7 Comparison of profitability of different credit card holders



Source: PwC analysis

In PwC's Precious Plastic 2006 report, we estimated that despite the introduction of balance transfer fees, 0% balance transfer offers were costing the industry in the region of £600 million per annum. It is now rare to find a 0% balance transfer deal where there are no transfer fees. Indeed, recent media reports suggest there are just three such offers. Over the last year, several lenders have raised the charge or removed caps to reduce the cost further. However, consumers who do not borrow are, at best, marginally profitable and issuers that are able to "encourage" consumers to build balances without resorting to costly balance transfer offers will be at a competitive advantage.

It is clear that a large number of consumers continue to take advantage of balance transfers despite the increasing cost of transfer fees. It is worth noting that some consumers have become conditioned to a relatively low cost of borrowing. For these, any further reduction in such offers could affect their ability to meet their debt obligations. This would not be a helpful trend as lenders are already facing significantly higher bad debt costs.

Regulation could cost the industry £1 billion a year

Recent and potential future regulation will put margins under further pressure and we examine regulation in more detail in Section 6. Card issuers have been hit by the decision on late payment fees and income from PPI and interchange remain under threat. PwC estimates that the combined effect of this actual and pending regulation could hit the industry's profit margins by as much as £1 billion per annum.

PwC has often talked about the "waterbed effect" - that is, issuers seeking to mitigate the impact of "lost income" from regulatory actions. Recouping £1 billion would equate to an increase in interest rates by a further 2 percentage points. Annual fees remain an alternative source of income and an annual fee of around £15 per card would be needed to generate income of £1 billion - assuming no one "cuts up their card".

There have been a number of instances where issuers have been criticised for not being entirely clear how certain offers or features of a card are applied, with the potential therefore for consumers to be misled and incur unexpected charges. There are also instances where the cost of use may be uncertain - for example, whether a fee is included in the exchange rate that applies when a card is used overseas. Adverse publicity does not help issuers gain the trust of consumers. We believe there remains further scope for simple, "honest" products, where all features are priced "at cost" with a "fair" APR and profitability maintained through a single annual or monthly fee.

As PwC predicted in last year's Precious Plastic 2006 report, credit card fees have moved up the agenda and we have seen some examples of selective introduction by certain issuers to segments of their customer base.

It is hard to say when annual fees will be introduced across the board as credit card providers will have to move cautiously in such a competitive market - no one provider wants to be the first to introduce the charges. However, PwC continues to believe it is only a matter of time before annual fees on credit cards become the norm.

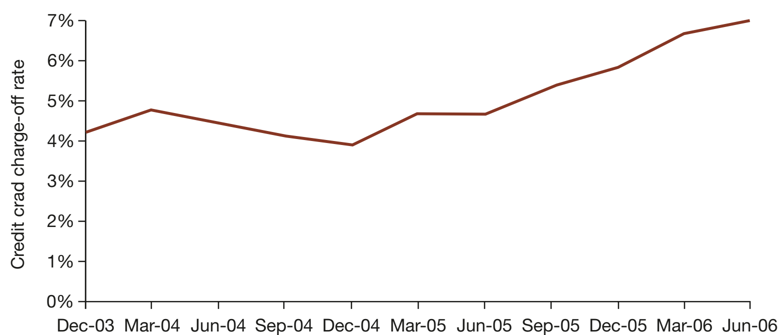
Section 2

Continued increase in charge-off rates

In PwC's Precious Plastic 2006 report, we outlined some of the complex drivers behind the increase in charge-offs since the start of 2005. The latest statistics show a worrying continuation of this upward trend. The increase in charge-offs is clearly more than just a temporary blip.

Charge-off rates continue to increase

Figure 2.1 Charge-off rates



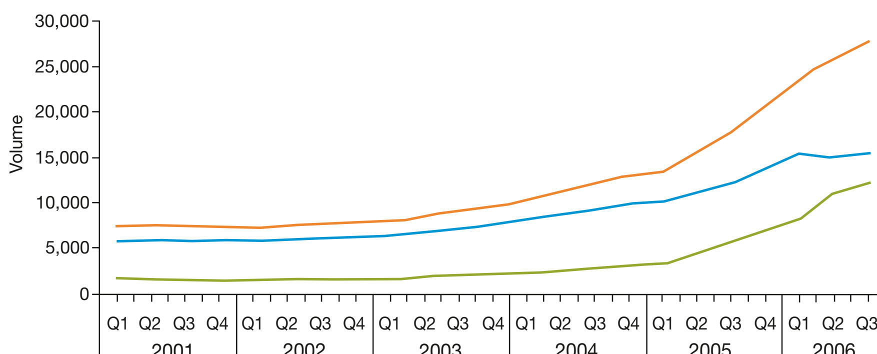
Source:
Standard & Poor's,
Credit Card Index Report, Q2 2006

As recently as December 2004, charge-offs (as measured by Standard & Poor's quarterly Credit Card Index Report), were below 4% per annum. However, since the start of 2005 there has been a steady upward trend, with the charge-off rate reaching 7% per annum by June 2006. The first quarter of 2006 saw a sharp increase in charge-off rates with the March figure up 0.8 percentage points from December 2005. The second quarter saw a lower rate of increase, which may signal the beginning of a levelling out.

Someone in the UK is now entering a personal insolvency every minute of every working day

The increase in Individual Voluntary Arrangements (IVAs) has been well documented, with someone now entering a personal insolvency every minute of every working day. In the last three years, PwC estimate the proportion of charge-offs due to insolvencies, has increased from around 20% to 30%.

Figure 2.2 Quarterly volumes of personal insolvencies



Source: Insolvency Service

IVAs reached a new peak in the third quarter of 2006 with 12,200 new cases, an increase of 10% on the previous quarter and 118% on the equivalent quarter in 2005. While this is still a significant increase, the rate of growth has slowed from over 150%, and it appears from some sources that the months of September and October showed a continued downward trend in growth rates. It is still too early to say whether this is a trend with some future or a seasonal blip following the summer.

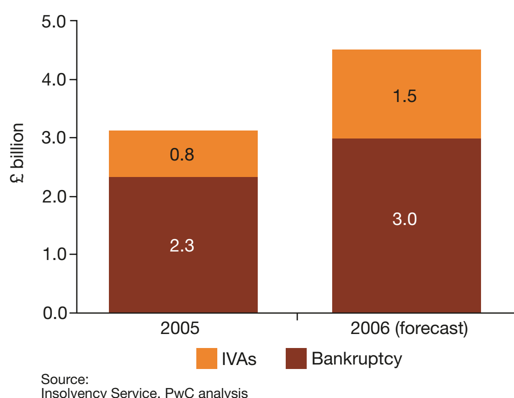
In contrast to the trend of IVAs, the number of bankruptcies has remained relatively static this year. This is attributable to the significant marketing of IVAs by debt management companies and the fact that an IVA does not have the same stigma attached or restrictions that declaring bankruptcy does. Although the number of bankruptcies declared in the third quarter of 2006 increased from the previous year by 27%, if latest growth rates continue, IVAs will be equally as prevalent as bankruptcies by 2007. The increasing prevalance of IVAs may be further enhanced by the introduction of the Simple Individual Voluntary Arrangement ('SIVA') expected in 2008. As the name suggests, this aims to simplify the procedure and to strip out unnecessary costs. The SIVA is aimed at cases where debts are not disputed and are under £75,000 in total.

Potential losses from personal insolvencies expected to reach £4.5 billion

There has been extensive media coverage recently about IVAs being too easy to apply for. The major UK banks have reported increased bad debts and some have blamed this increase on the ease of the IVA system.

PwC estimates that bankruptcies and IVAs will cost lenders £4.5 billion in losses in 2006, an increase of £1.4 billion on 2005.

Figure 2.3 Potential losses from IVAs and Bankruptcy



Source:
Insolvency Service, PwC analysis

IVAs are beginning to be used as a means of avoiding interest payments

PwC examined 6,481 IVAs registered between July and November 2005 and found that the average debt was £60,000. Over 80% of insolvencies were caused by people simply living beyond their means.

PwC has visibility over a large proportion of the personal insolvency market and we are now seeing a new trend - a growing proportion of individuals seem to be using IVAs as an easy option to avoid interest payments. This group appears to have the capacity to repay the capital over a period of time not dissimilar to the original term of their indebtedness, as witnessed by their proposed payment schedule under the IVA.

Will personal insolvencies continue to increase?

Personal insolvencies have increased from fewer than 30,000 in 2000 to, we estimate, 105,000 in 2006. To analyse this growth and forecast future levels, PwC has prepared a macroeconomic model to consider the levels of insolvency against the key drivers: household interest payments, undrawn housing equity, unsecured debt levels and changes in legislation. The historical data analysis has allowed us both to isolate and assess the relative importance of these variables to provide a forecast, and to estimate the potential impact of the dramatic rise in debt management companies on the number of personal insolvencies.

The macro-economic model created by PwC indicates that insolvency numbers will continue to rise by, on average, a further 20,000 a year from 2007 to 2009 before reaching a peak of 190,000 in 2010. The model indicates that beyond 2010 we might then see cyclical factors reverse some of this growth, with overall numbers declining perhaps during 2012.

When considering likely future trends it should be borne in mind that external influences, such as the introduction of the SIVA, interest rate increases, and creditor attitudes could have a major bearing. On the one hand, the introduction of the SIVA could result in a significant structural shift in the market - in this case actual levels of personal insolvencies could be well above our forecast. On the other hand, creditor banks may not allow the numbers to increase in this way and could harden their stance on acceptable levels of dividend.

A number of institutions have been critical of the role that debt management companies play in encouraging personal insolvency. Our analysis indicates that such companies have had an impact although it is very difficult to quantify. It is clear that cyclical factors alone would not have resulted in the sharp rise in insolvencies. The consumer credit boom has created a fertile environment in which debt advisers have been able to promote the IVA. The industry that has developed around this arrangement has certainly played an important role.

Responsible lending

In an attempt to improve credit decisions, banks have looked to data sharing with other lenders. In March 2006, four of the UK's biggest banks announced a scheme to provide Callcredit, an independent credit reference agency, with data about customers' income and level of debt. This scheme, which took two years to put together, is a positive step for the industry and will go further than previous data sharing because it is expected to highlight those customers who have taken on too much debt relative to their income. HBOS, HSBC, Lloyds TSB and Royal Bank of Scotland should be able to identify and closely monitor those accounts which are severely over-indebted, and this could help these banks in determining whether to accept future credit applications. This scheme has followed the example of a separate initiative, set up by Barclaycard and other lenders in December 2005, to share increased customer data. This shows a desire by banks to know more about the customers they lend to in a bid to cut bad debts.

Other initiatives have also been announced during 2006. For example, one issuer recently stated that it is changing its terms and conditions to allow it to refuse to authorise a transaction if it thinks a customer is spending beyond his means, even if he/she has not exceeded his/her credit limit. As a further example, Barclaycard has introduced a new clause into its standard terms and conditions, which allows credit limits to be cut or to restrict the amount a customer can withdraw from a cash machine.

Section 3

Retailers and consumer credit

In previous editions of PwC's Precious Plastic reports, we have commented on the rationale for, and attractions of, financial institutions entering into partnerships with retailers or well-established consumer brands. Over the last five years, we have seen most major retailers renegotiate such arrangements with their existing partner or enter into a new partnership with a different financial institution. This period of change has seen the retailer in the driving seat, providing them with the prospect of increasingly favourable returns. The challenge for the financial institutions that have participated in such auctions will be to achieve a satisfactory return on their investments.

Many of the major retailers are seeking to capitalise on their brand and existing point-of-sale customer base to create broad-based financial services businesses. These developments offer the prospect of significant returns to both the retailer and their partner. However, while we expect to continue seeing new propositions, PwC believes that a relatively small number will be truly successful.

In Section 6 we comment on the findings of the Competition Commission in connection with the store card market. This investigation put store cards firmly in the spotlight and has had an impact on new applications. However, we continue to believe that there will remain a role for store cards in the point-of-sale finance market. Many consumers value the benefits they provide and the affinity with the retailer brand. Despite the continuing trend towards retailer-branded credit cards, we continue to believe that a store card offering will remain important for many retailers.

Section 4

Card market innovations

Loyalty and the conscience consumer

As discussed in Section 2, a large number of card users are unprofitable and, in an environment with an increasing cost of regulation and a rising default rate, PwC believe loyalty schemes will be reassessed. Bland points-based schemes may not have the desired effect of increasing spend, and schemes aimed directly at rewarding those who borrow is not a route that lenders would wish to take.

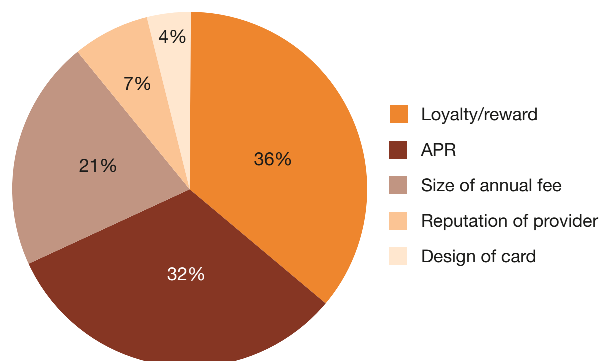
In PwC's Precious Plastic 2006 report, we predicted a shift in the focus of loyalty schemes towards those that offer affinity towards the lifestyle of cardholders. The decision by American Express to join the RED programme and launch the RED card in 2006 is an excellent example of such a scheme. One per cent of all card spend is contributed to the global Aids charity, rising to 1.25% when spending exceeds £5,000 a year. American Express also contributes £5 when the card is used in the month following issue.

This initiative illustrates the desire of card providers to offer a differentiated product to customers. American Express stated that it had observed the growing trend of the "conscience consumer", estimating there are currently 1.5 million such consumers in the UK, a figure it expects to increase to 3.9 million within three years.

While cards supporting charitable causes are not new to the UK market, the RED card is aimed at a wider segment of the population than existing affinity schemes. PwC sees scope for other propositions aimed at appealing to "conscience consumers".

PwC has conducted an online poll to establish the most important factors considered by consumers when choosing a credit card. As shown in Figure 4.1, the poll found that 36% of the consumers who took part believed loyalty and a reward scheme was the most vital to them when making their decision. The APR of the card was the second most important factor, with 32% of the participants referring to this factor influencing their decision.

Figure 4.1 Precious Plastic poll



Source: PwC analysis

A further trend in developing loyalty is the “bundled product” where, for a relatively modest fee, consumers are offered a range of benefits. One such example is the Lloyds TSB Premier Card. A monthly fee of £4.95 provides the cardholder with a number of benefits including a concierge service. Such schemes illustrate how card providers are aiming to generate loyalty by introducing credit card fees in return for offering tailored programmes.

The prepaid market is growing rapidly

In PwC’s Precious Plastic 2006 report, PwC anticipated the introduction of more prepaid cards in the UK market and there are now many examples in the UK market.

The use of prepaid cards is becoming increasingly popular in the travel industry, where customers can load up their card with currency and use it abroad. Travelex has launched a prepaid Visa travel card called Cash Passport. MasterCard also has a prepaid card in the travel market (with the Western Union Travel Cash Card), and American Express has launched a Travellers Cheque Card. MasterCard also has ties with some airlines who are using prepaid cards to provide compensation to passengers who are delayed or have lost their luggage.

Contactless payments round the corner?

In PwC’s Precious Plastic 2006 report, we commented on Transport for London’s (TfL) plans to expand the scope of the Oyster Card to allow customers to purchase a variety of small, everyday items with their card. However, in May 2006 TfL announced it was abandoning the project owing to the expense and complexity of setting up a link with a financial partner to develop the service.

However, other organisations have seized the opportunity. Nucleus plans to launch in London an e-money card called sQuid in early 2007, followed by a nationwide roll out. sQuid is a prepaid card which can be loaded with a maximum of £50 and used for small convenience purchases.

Visa has successfully trialled its “Contactless” technology in four Asian countries and in the US where around 10 million shoppers now purchase goods this way. The trial will be extended to the UK this autumn. MasterCard PayPass rollouts and trials have been announced in 13 countries. As of second quarter 2006, there were 10 million MasterCard PayPass cards/devices in market and over 32,000 merchant locations deployed globally. In the UK, the Royal Bank of Scotland has been trialing MasterCard PayPass in which purchases up to £10 can be made using the card. RBS is testing the system among RBS employees at their head office which has 8 convenience shops.

As contactless payments are introduced, retailers who are quick off the mark will gain a competitive advantage. Contactless payments cut down queuing times and may even establish loyalty for retailers who have their own branded card. An example of this is a café chain which has recently trialled the system in 22 of its outlets. The card can be loaded, on-line or in the café, with between £5 and £75, which makes purchasing a coffee much easier. It also awards points for loyalty, which may help with customer retention.

The US is currently the largest market for contactless payments. With trials taking place in the UK, launch here is imminent. Around 80% of cash transactions are purchases of less than £10. Therefore the potential market for prepaid contactless transactions is enormous.

Is the UK ready for another innovation? With customers and merchants only now getting used to the roll-out of Chip and PIN, it may be a while before “touch and go” payments take off. The other question is that of security on the cards. To overcome fraud, shoppers may be required to enter a PIN number after a random number of transactions. PwC expects the take-up of these smartcards to be slow at first, but once the systems are launched across a wide range of merchants, the cards could be very successful. This has been seen in the US, where around 30,000 retailers accept contactless payments.

Yet with technology developing at a rapid rate, contactless cards may be superseded before they take-off. According to a recent research report published by The Institute for Grocery Distribution, a retail think-tank, shoppers in the future will be able to purchase goods using a microchip implanted in their body. The report highlighted the willingness of teenagers to have a microchip the size of a grain of rice implanted under the skin. In the immediate future, however, supermarkets may look to using a range of simpler biometric payment methods including fingerprint and iris recognition. Fingerprint technology is currently used by more than 2.3 million shoppers in the US. This innovative payment method has also been trialled in the UK.

Section 5

Comparison with international markets

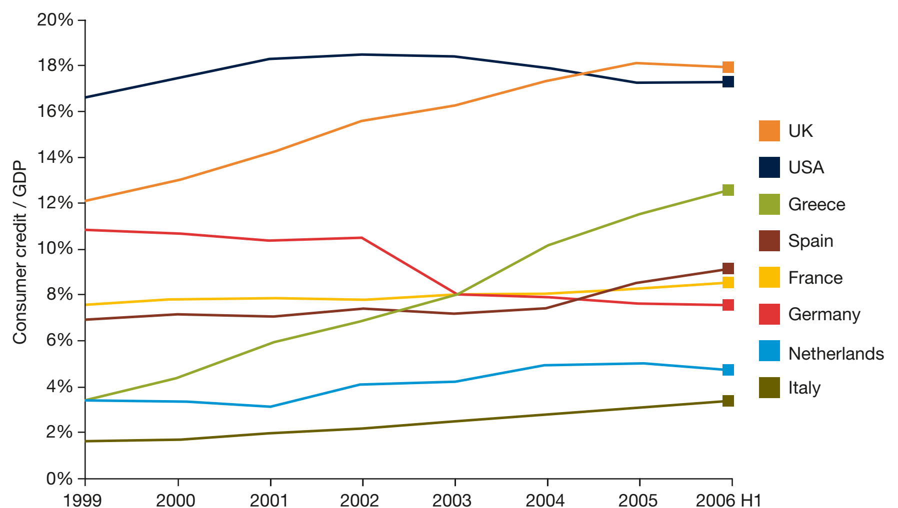
UK consumers are now even more leveraged than their US counterparts

The total debt of the UK population (secured and unsecured) now totals 104% of gross domestic product (GDP) compared to just 92% in the US. For the first time ever, 2005 saw the penetration of consumer credit in the UK economy overtake US levels, with the outstanding level of consumer credit reaching 18% of GDP. This compares to just over 17% in the US and is approximately double that in the large Eurozone economies. The average UK consumer is therefore now carrying the highest level of unsecured debt relative to income in the OECD countries.

This situation is the result of a period during which UK consumer borrowing growth rates exceeded those of the US. In 1999, the outstanding level of consumer credit in the US economy was nearly 17% of GDP, compared to a notably lower UK figure of 12%. Over the next few years, US consumer credit penetration increased steadily, reaching a peak of 18.5% in 2002. It has since declined gently, reaching 17.3% in June 2006. During the same period, the previously less-developed UK market grew at a steeper and more sustained rate, reaching its historic high point of 18.1% at the end of 2005 before declining marginally to 17.9% by June 2006.

It is certainly striking that both countries have so far reached very similar peak levels of consumer credit penetration. The idea that consumer borrowing levels might have a “natural ceiling” may be appealing, but is there any reason to believe that the UK will follow a similar profile to that of the US? If the history of secured consumer borrowing in the two countries is any guide, then the answer may be “no”. Levels of secured borrowing as a proportion of GDP were nearly identical in the US and UK between 1996 and 2001, but have diverged since 2002. US home mortgage penetration reached 75% in June 2006, but growth in the UK has been more rapid, with the level of consumer mortgage debt reaching 86% of GDP. So while growth patterns in the two countries do seem to exhibit some similarities, it is not yet clear whether the UK consumer credit market will remain at levels similar to those seen in the US.

Figure 5.1 Consumer credit as a percentage of GDP



Source: Central Banks, Eurostat, PwC analysis, all dates as at December (except 2006, June)

Most Eurozone countries are not even close to UK consumer credit levels

The rapid growth in UK consumer credit in recent years means that between 1999 and 2005 British consumers extended their borrowing gap over their major continental counterparts, contradicting any impression that most other European markets have been catching up with the UK. As Figure 5.1 shows, the proportion of outstanding consumer credit to GDP within European economies has varied considerably since 1999. Greek consumer credit has grown steeply over the past six years, but this trend is the exception to the Eurozone rule and has not been replicated in the larger Eurozone economies. After several years of slow growth, Spain experienced rapid expansion during 2005 and 2006, while both France and Italy have seen steady growth from a low base over a number of years. However, consumer credit penetration declined slightly in the Netherlands during 2006, and in Germany unsecured personal borrowing as a percentage of GDP has actually fallen in all but one of the last six years. The result is that the total amount of consumer credit in the UK economy is now roughly equivalent to that of France and Germany combined.

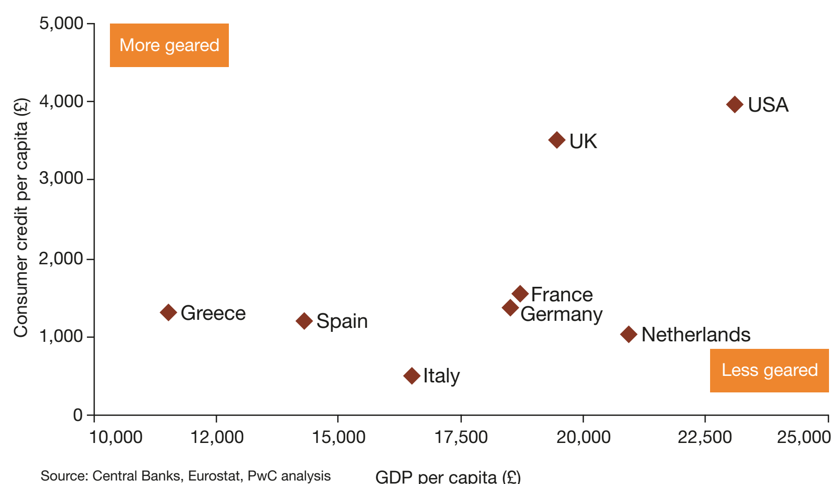
Given the continuing differences in consumer credit penetration between the UK and the Eurozone, it is natural to ask whether the gap will ever be closed. In the long-term, a degree of convergence can probably be expected, if only because UK consumer credit penetration cannot continue to expand indefinitely, and consumers in most major European economies clearly have the potential to increase their personal leverage.

Some European markets appear more likely to catch up the UK than others

A comparison of consumer credit penetration levels between European countries suggests that growth prospects vary widely and are not always related to the strength of national economies. Figure 5.2 shows a country-by-country comparison of consumer credit per capita with GDP per capita. Logically, countries with higher levels of GDP might be expected to sustain higher levels of consumer credit. However, the plot of data points provides little evidence of correlation, implying that cultural and other factors are probably more important than economic considerations.

In Spain, consumer credit per capita is comparable to that in Germany and France, but is supported by a much lower level of GDP per capita. Despite having a relatively low level of consumer credit per capita, the average consumer in Spain is therefore more highly geared to GDP than his or her counterpart in France or Germany. This reflects the rapid growth in Spanish consumer credit since 2004, which has been driven by negative real interest rates and a generous supply of credit by domestic banks and foreign entrants. As a result, while the Spanish consumer credit market may offer scope for further growth in the short term, the prospects for longer-term expansion appear more limited than in some other European countries. Meanwhile, the development of the Greek consumer credit market resembles the recent experience of Spain. The penetration of unsecured borrowing in Greece has expanded at a rapid annual rate for the past six years, moving from a very low base to one of the highest levels in the Eurozone. The key drivers of growth have been strong economic growth, low real interest rates and a cultural shift in Greek financial habits.
As in Spain, market analysts expect growth rates to remain strong during 2006, but do not view the current trend as sustainable in the medium term. Unlike their Spanish counterparts however, Greek consumers have considerable scope to increase their mortgage borrowing and many analysts predict this type of lending will take up the slack as consumer credit expansion slows.

Figure 5.2 Consumer credit per capita versus GDP per capita 2005



Source: Central Banks, Eurostat, PwC analysis

Although France and Germany have similar levels of both consumer credit and GDP per capita, placing them both in the middle of Figure 5.2, the two countries have arrived at this point by very different routes. France's appetite for consumer credit has increased slowly but steadily in recent years. A strong supply of credit by France's large domestic banks and increasing house prices also suggest that the French market should have good scope for further growth in the medium to long term. In Germany however, the penetration of consumer credit in the economy has fallen by 30% since 1999. This exceptional trend reflects an ever-stronger propensity to save and a continuing indifference to the consumer credit culture taking root elsewhere in Europe. German politicians and business leaders may have been hoping that consumer spending might give the economy a boost, but take-up of credit cards is low for such a developed economy and users remain reluctant to revolve balances. Considering this track record, the outlook for consumer credit growth in Germany must be considered uncertain.

In contrast, based on their positions in Figure 5.2, Italy and the Netherlands appear to offer greater scope for consumer credit expansion. Once again though, cultural differences suggest that actual growth potential varies between the countries. Although Italians have shown an increasing appetite for consumer credit in recent years, the average consumer is extremely under-borrowed compared to other European markets. This has led Italian and foreign banks to predict long-term expansion in consumer borrowing, and this potential has been cited as a key motive for investment. At first glance the Netherlands appears to offer strong scope for consumer credit growth, considering its high level of GDP per capita. This impression is further reinforced by the extremely high level of secured consumer borrowing in the Netherlands, the result of widespread home ownership and a history of tax incentives. However, credit card usage is very low with approximately two million cards in issue among a population of 16 million. This low adoption has been attributed to the heavy promotion by Dutch banks of debit cards. The result is that while Dutch consumers may use credit cards for payment abroad, they typically prefer to use debit cards for day-to-day domestic use.

Cultural factors remain crucial to growth prospects in Europe

Overall, the prospects for growth in the major European consumer credit markets look extremely varied, with cultural preferences likely to remain the key differentiator. Many lenders expect the French and Italian markets to continue their steady expansion, while the Spanish and Greek markets are viewed as approaching their peaks of growth. In contrast the German market is not widely predicted to reverse its well-established decline.

Section 6

Regulation continues to be a major issue for lenders

Regulatory pressure on the consumer credit market continued unabated through 2006. The Office of Fair Trading (OFT), the Competition Commission (CC) and the Financial Services Authority (FSA) all pursued separate investigations into the sector. The retail banking sector as a whole has been the subject of intense regulatory scrutiny.

Store cards resolved, but unlikely to have a major impact on the market

In March 2006, the CC published its final report on the store cards market. It found that average APRs were 10% to 20% too high, costing the consumer at least £55 million a year. The sector average APR was 26.5%, but the CC calculated that APRs reflecting costs would have been in the 22% to 24% range. The CC said that retailers and store-card providers were "effectively insulated from competitive pressures".

The CC has imposed a number of remedies. Where APRs are 25% or above, monthly statements must warn cardholders that credit may be cheaper elsewhere. Customers must be offered the opportunity to pay by direct debit and payment protection insurance must be sold separately from other elements of store card insurance. More and better information must be provided on monthly statements.

Consumer groups responded that the measures did not go far enough. It should be remembered, however, that the average outstanding balance on a store card is around £150 and while there will be a small proportion of users who rely too heavily on store card credit, the majority do not. Any reduction in APR is therefore insignificant to most store card users. As default rates across the industry continue to rise, institutions will be under pressure to reduce acceptance rates, particularly if the remedies in effect act as a price cap. This could potentially lead to a segment of the population being unable to obtain store card credit. These same consumers are also likely to have limited access to other mainstream credit.

The interchange fee debate goes on and on...

In September 2005 the OFT published a decision in which it determined that the interchange fees for MasterCard domestic UK transactions, in effect between 1 March 2000 and 18 November 2004, violated UK and EU competition law. An interchange fee is the fee that is paid by merchant acquirers to card issuers on credit card transactions. The interchange fees which were the subject of the OFT's decision had been set by MasterCard UK Members Forum which represents MasterCard issuing and acquiring banks. Because these fees were set collectively by the banks, they are called 'multilateral interchange fees'. The average level of credit card interchange fee in the UK in recent years has been in the order of 1% of the transaction value. The OFT claimed that these fees led to higher prices to consumers.

In June 2006 the Competition Appeals Tribunal set aside the OFT's decision after the OFT sought to withdraw it voluntarily. The OFT ended its investigation of MasterCard's pre-18 November 2004 (multilateral) interchange fees but said it would continue to investigate MasterCard's post-18 November 2004 UK domestic interchange fees, which are now set unilaterally by MasterCard. The OFT is also investigating Visa's UK domestic interchange fees. The OFT said "we still believe that the interchange fee arrangements that are now in place could infringe competition law and are harmful to consumers".

Competition authorities in other jurisdictions, including Australia, have taken a similar line to the OFT. In Australia, card associations have argued that there is no proof retailers have cut prices to consumers. There has been a change in the structure of other charges and benefits and commentators estimate that banks have recovered up to 40% of their lost revenue. A study for the Federal Reserve Bank of Kansas suggested that, in countries where interchange fees have fallen, annual card fees have risen.

Consumer Credit Directive

As if the need to comply with a heavily refined Consumer Credit Act 2006 (CCA) is not enough (see PwC's Precious Plastic 2006 report), a new set of rules and requirements will be introduced when the Consumer Credit Directive (CCD) is adopted, a revised draft of which was produced in September 2005.

The CCA's purpose is to reinforce the single market by harmonising rules across the European Union (EU) on the selling, advertising and regulation of credit.

It will apply to credit up to €50,000 but will not apply to secured lending and hire or loan agreements (unless title eventually passes). Hence it will apply to a narrower range of credit than the CCA.

Changes arising from the CCD that will necessitate revision to standard form consumer credit agreements when it comes into force are likely to be:

- Additional obligations in respect of form and content.
- Pre-contractual and contractual information requirements which differ from the CCA.
- Certain content requirements which under the CCA are required will need to be removed, (details are yet to be finalised).
- The concept of responsible lending will be introduced which it is believed will reflect the similar concept which has been introduced under the CCA.

Of more concern for creditors is a "no fault" right of withdrawal which will be granted to debtors entitling them to pull out of an agreement and any collateral agreement at any time up to 14 days from its signature, for no reason.

The EU Commission perceive the introduction of the CCD as resulting in long term cost savings, increased competition and a reduction in interest rates for consumers. The CCD also introduces the concept of mutual recognition: in principle an entity that is licensed in one member state to provide credit shall in respect of services that are exhaustively regulated by the CCD be permitted to do so in any member state within the EU. Theoretically this would enable entities from less regulated states to have a financial and competitive advantage as a result of the lower cost of regulatory compliance to their competitors in member states that have a higher cost of regulatory compliance. The opportunity to lobby and canvas the DTI and forward comments on the CCD, should the opportunity arise, be seized.

Source: Simmons & Simmons

Lenders are likely to be hit by the investigation into PPI

In October 2006, the OFT signalled its intention to refer the market for PPI to the CC. The OFT said: "Following the work we have undertaken, it is clear that many consumers are failed by PPI - insurance which gives them a poor deal and often less protection than they think. There is limited evidence the industry is taking steps to improve the situation, but we believe they will not make major improvements to competition in the market." The announcement came after a six-month market study of the £5.5 billion-a-year market.

In its report, the OFT stated that "with very few exceptions competition does not take place on PPI at all". It found that the point-of-sale advantage experienced by distributors was the central feature adversely affecting competition. Stand-alone providers had difficulty in accessing customers, and suppliers had little incentive to provide customers with relevant information. The OFT's initial estimate of the consumer savings that could be made by making the market more competitive was around £1bn.

The average claims ratio for the industry was 19% for 2005, compared to 54% for household insurance and 82% for motor insurance. The OFT suggested that these differences were wide enough to be "beyond questions of differences in comparability or risk", implying sizeable distributor profits. It also found evidence that these profits were being used to subsidise low margins in the provision of some unsecured loans and credit cards. It said this might lead to a situation where consumers who did not take out PPI were being subsidised by those who did. A six-week consultation period follows the publication of the OFT's report, and a final decision on the market's referral will be taken in early 2007.

The OFT's work was influenced by separate studies carried out by the FSA into PPI and the CC into store cards. The FSA published its own review of the PPI market in October 2006. It found there had been some improvements in sales standards since a study it carried out in 2005. There were, however, still serious concerns, particularly over the quality of information being given to consumers during the sales process. The FSA is following up remedial programmes with a number of firms and is also considering whether new rules are required in the area of PPI. As part of its store cards investigation, the CC criticised providers for bundling PPI with other products, and noted a lack of competitive pressure on insurance premiums.

The ruling on default fees has almost certainly led to higher interest rates

In July 2005, the OFT issued provisional conclusions on its investigation into credit card default charges. These are paid when customers fail to pay a bill on time or exceed their credit limit. The OFT said that the charges, usually in the £20 to £25 range, were "disproportionate" and "unfair". In April 2006, the OFT confirmed this finding. It stated that a fair default charge should not exceed the level of the administrative costs usually associated with a default. It estimated that unlawful penalty charges were currently in excess of £300 million a year.

The OFT set a threshold for intervention at £12. Any default fee above that level would be presumed unfair, and would be challenged unless there were "exceptional business factors". Many card issuers stated that they did not agree with the OFT's assessment, but they nevertheless agreed to reduce their charges. It is interesting to note that since the OFT ruling, it has been reported that 19 card providers have increased their interest rates.

The OFT also said that the broad principles applied to default charges would be likely to be relevant to other areas. It has decided to undertake work on the application of these principles to bank current accounts. In September 2006, it announced that it would be carrying out a three to six-month fact-finding exercise, before deciding whether a more detailed investigation was needed.

Other regulation

In June 2005, the European Commission (EC) launched an inquiry into the markets for payment cards and retail banking. During 2006, the EC published interim reports in both these areas.

In the payment card market, large price differentials between member states were seen as evidence of barriers to cross-border competition. “Network rules” and “joint ventures” were highlighted as a problem. The model for interchange fees was also criticised. The EC said that the current system amounted to a tax on businesses and consumers and had led to abnormally high profits over a sustained period of time. The industry has been encouraged to explore ways to address these perceived issues. The possibility of anti-trust proceedings by the EC remains open.

Overall approach

The consumer credit sector is under sustained pressure from regulators. A large number of investigations are already in progress and interest in the sector remains high.

Currently, perhaps because they have not traditionally been the subject of economic regulation, institutions do not seem to be making an effective case to regulators. Although the store card investigation resulted in relatively benign informational remedies, this was not the case with the issue of default fees and significant sums are at stake for lenders.

The consumer credit industry undoubtedly has some of the most consistently negative and one-sided media reporting of any industry in the UK. This negative publicity and resulting political pressure is likely to be a driver behind recent regulatory initiatives. The consequences of continuing regulatory pressure will be lost revenues and a further increase in compliance costs.

The consumer credit industry provides major benefits to consumers and the economy as a whole and these benefits need to be properly explained. Regulation remains one of the key issues for the consumer credit industry.

Conclusions

1

The growth in consumer credit slowed considerably this year and balances are now showing a very different trend to that observed over the previous five years. With a slowdown in the market, significantly higher bad debts and an ever-increasing cost of regulation, times have got tougher for lenders.

2

Charge-off rates continue to increase, driven in part by the rising number of personal insolvencies. Personal insolvencies will exceed 100,000 this year and are likely to cost the industry £4.5 billion. PwC is seeing a worrying trend where IVAs are being used by a certain group of consumers as a means of avoiding interest costs.

3

Regulation remains a key issue for the industry. PwC estimates that the impact of the recent ruling on default fees, combined with the potential impact of current investigations into interchange fees and PPI, could cost the credit card industry £1 billion per annum in lost revenue. The targeting of the same profit pool by the various different inquiries is leading to the “waterbed effect” - that is, costs are simply reallocated between different groups of consumers. It remains to be seen whether a more equitable position will be reached.

4

Margins continue to be under significant pressure and lenders are now operating in a market which is unlikely to grow significantly. This will encourage lenders to consider carefully their cost base and look increasingly to economies of scale. The largest institutions may therefore seek a further globalisation of their operations to assist them in achieving cost competitive advantage.

5

Several years of rapid growth in consumer credit penetration have cemented the UK’s position as one of the world’s most developed markets for unsecured borrowing, even surpassing that of the United States. The average UK consumer carries more unsecured credit than an average consumer in France and Germany combined. While expansion in the UK has clearly slowed in 2006, there are no real indications that the large Eurozone economies will even approach UK levels of penetration in the next few years. UK consumers look likely to remain the leaders of unsecured personal leverage for the foreseeable future.

About PricewaterhouseCoopers

The Valuation & Strategy team of PricewaterhouseCoopers is the leading adviser in the UK partnerships and consumer credit market. We offer a unique perspective, derived from working with all types of market participants, 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:

- Transaction and investment decisions
- Market analysis
- Strategy and business plans
- Partnership strategies
- Contract negotiations
- Valuations

Financial institutions

We can help you to maximise the returns being generated by your consumer credit operations by devising strategies that deliver profitable growth, either organically or through acquisitions and joint ventures. By drawing on our industry experience, we conduct market and valuation analysis to help you choose the best strategy when considering an investment.

We provide real insight into your investment decisions, assessing the trade-offs between risk and reward.

Retailers and other non-financial institutions

We work closely with you to identify how to increase the direct and indirect benefits you receive from your financial services activities, by providing you with a clear and unambiguous evaluation of your options.

For example, we can advise on products to be offered, potential partners and the structure of any relationship aiming to ensure that the financial services proposition is consistent with your organisation's core business strategy.

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