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The next steps for non-prime

Dr Roger Gewolb, one of the founders of the non-prime and sub-prime motor finance industry in the UK, gives an overview of recent changes to the market, and indications as to its future development

In the almost 15 years since I bought British Credit Trust from Bank of Ireland, I've never seen a situation such as exists today, where there is effectively no subprime or even non-prime finance capacity.

Welcome Financial Services is gone. But it would appear from press reports that its listed parent company Cattles was heading in that direction for a long time anyway, and its demise was only hastened by the credit crunch and the consequent funding crisis.

All the other major players have disappeared, their funding lines having been ceased as part of the overall systemic deleveraging by wholesale bankers that was the first stage in confronting the effects of the credit crunch. The crisis of confidence that pervaded the market, when motor finance lines for all but the most prime funders were stopped or drastically reduced, as an adjunct to the much larger non-prime mortgage lines that were pulled.

But history shows that the British car owner is always pretty good about making car payments – recognising that the car is an essential tool. For more on how the finance providers threw out the motor finance baby with the subprime mortgage bathwater, see my article in *Motor Finance*'s April 2009 issue.

There now exists, therefore, a huge market gap and a consequent opportunity in near-, non- and subprime motor finance such as we have not witnessed before.

I received a number of approaches from both equity sponsors and debt providers from here and abroad who see the tremendous opportunity in the market, where anyone with any kind of credit impairment cannot easily get finance for a car, and where the credit bar overall has been raised.

Securitisation is already starting up again, with recent issues from Volkswagen, Ford Credit and Lloyds TSB as well as other issues, and it is clearly the intention of all government regulators to get the securitisation market moving again.

So when the non-prime motor finance market does revive, what will it look like? Who will fill the gap in the market? Will the prime lenders look into providing non-prime? No: they're not equipped for it, in terms of corporate ethos, staffing, systems or even clientele. Looking at a parallel market, a big effort has been made to get prime mortgage lenders to fill the subprime mortgage gap, but none has apparently been willing to do so, and I do not think motor finance will be any different.

■ Gewolb: a huge market gap now exists

Will past players be brought back to life through acquisitions? Again, I get regular approaches on this topic but nothing concrete has materialised as yet.

Outsourcing of processes

How will possible new entrants into the subprime zone operate? Will they outsource processes?

I have been in the industry since the beginning and it has been proved time and again

that outsourcing processes or using 'virtual' financial services companies does not work for non-prime and subprime.

You cannot 'farm out' underwriting, payouts, arrears management and collections for anything below near-prime. These processes all have to be controlled in-house in an open-plan trading floor, with highly experienced managers right in the thick of it.

A subprime point of sale business can very quickly spin out of control once things start to go wrong, so managers must be aware of everything that happens in order to nip problems in the bud every day. (Hey, that's why you get the big bucks – for example big margins.)

I was recently interviewed by a bond rating agency, which said that its biggest concern is that when things go wrong, there is a big question as to whether standby servicers can cope as well as they should.

Funding lines, and loan criteria and conditions, will initially be much tighter than before, even for those lenders which are currently lending out small amounts of the rentals coming in every month, in order to keep business ticking over.

Having said all the above, I think the current moribund state of the market is a shame, as despite some players having made mistakes with loan-to-value ratios, commissions, and so on, the UK subprime motor finance market is filled with exceptionally talented people, capable of serving the needs of a huge number of customers.

In 2006, Datamonitor said that more than 15 percent of the population fell into the subprime category (9 million out of a population of 61 million). That was two years before the credit crunch, when the economic outlook was decidedly rosier.

I have read recent projections that at least one-third of the UK population is now non-standard. That's an extraordinary chunk of the UK population, and we have more than enough talented people from this grossly shrunken industry to serve it.

The smaller players, especially if they are acquired, may be able to raise additional capital and debt and increase their market share. We may also see the appearance of speciality motor finance companies, serving a variety of niches – dealing with certain types of car, for example, or particular localities and so on.

This market needs to be consolidated - previously, there were too many small players. We need to see the emergence of an industry major which serves all segments, not just subprime, as did Welcome.

Changes in customer behaviour?

Have subprime customers changed, as a result of the credit crunch? Previously, good customers were people with the willingness and the ability to pay; a good subprime customer had had trouble in the past, and wanted to rebuild his credit rating, so demonstrated good repayment behaviour.

What the industry needs to ask itself now is whether the way that the public now seems to hold banks and lenders in low regard means that customers' loyalties have changed – and how, in turn, this will affect their behaviour.

It may well be the case in the area of unsecured lending that arrears management and collections become more difficult.

But I believe that in motor finance and first mortgage lending, the threat of repossession following default remains unchanged, and may even be stronger, given the sensitivity to future losses that lenders – many of them bailed-out – may experience.

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Furthermore, customer sensitivity to the relative sparseness of finance options outside the prime world could also engender better debtor behaviour.

The possibility of a usury ceiling has been raised, as a result of the credit crunch, the subsequent financial crisis and other controls introduced on compensation, bonuses, leverage, proprietary trading and so on, but I do not think one will be brought in.

First of all, the Consumer Credit Act of 2006 did not include any rulings on interest rate ceilings in its final form, and although parliamentary debate on this point has carried on, there is no serious political appetite to introduce such a measure.

When the insertion of such a measure was being introduced, it is notable that even the Citizens' Advice Bureau, along with many other consumer protection bodies, argued against its inclusion in the final bill.

Second, it has long been perceived in the UK that to introduce a usury ceiling of, say, 20 percent APR, as was the aim of a three-faith demonstration in the City, would be naïve – inasmuch as subprime lenders simply cannot make money for the risk they take on at that level of interest.

Subprime customers would thus be driven into the arms of unregulated loan sharks. Successive governments have been well aware of this danger, namely that of leaving credit-challenged, socially marginalised customers totally unprotected.

Responsible lending guidance

The subprime motor finance market perhaps has less to fear from the Office of Fair Trading (OFT)'s draft guidelines on irresponsible lending than might be expected.

For example, in non-prime lending, no finance house makes loans without a statement of income, as the OFT suggests. Most of the consumer lending protection measures are already used as self-defence mechanisms by subprime motor finance companies in any case.

It is undeniable that the very term "subprime" has had some bad press since the start of the credit crunch. Subprime motor finance, however, has mostly escaped this bad press – with the exception of Cattles, although its problems were allegedly caused by improper provision in any case.

The subprime mortgage industry has had a huge amount of bad publicity, both here and in the US, but I do not think that this negative press will affect car buyers, dealers, brokers or any subprime lender to consumers.

However, it has egregiously affected wholesale lenders – who fund subprime finance houses – and that is the reason for the lack of supply of non-prime motor finance.

Those wholesale lenders will return to the market eventually, albeit softly and gingerly at first, but return they will – especially as the securitisation market recovers.

Past lessons

Commissions paid to dealers for introducing subprime customers have almost disappeared from the market. Will we see a return to the commission wars of the past?

I think it unlikely, as companies which return to this market, or which set up new operations, will need profits to repair their balance sheets, rather than giving money away in the form of commissions.

Supply will eventually return to the market, and when it does, we will see whether the industry has learned the lessons of the recent past regarding loan-to-value ratios, high commissions, and so on.

It is clear that the subprime motor finance industry faces many challenges – in my long experience in the industry, I do not think I have ever seen conditions as tough as they are at present.

But I believe that the majority of people within the industry will learn the lessons of the present, and will apply those lessons in the future.