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What is the future for motor finance?

NEWS: GM's future in doubt

SPECIAL REPORT: Risk management

PROFILE: HSBC Vehicle Finance

CONTENTS

Cover story

16-19 THE ROAD AHEAD

Well-known motor finance industry expert Dr Roger Gewolb sets out the future for consumer motor finance in the UK as he sees it, assisted by Business Economics Ltd

Motor finance

12 BALANCING RISK AND REWARD

Risk management has never been more important for finance houses than at present. Two captive companies tell **Antonio Fabrizio** how they are managing risk during this unprecedented period of market downturn

23 Excerpt: More *Expert Opinion*

NEWS

4-5 Consumer news
6 Fleet news
7 Company results
8-9 Fleet deals
10-11 On the move
11 Technology

MOTOR FINANCE

12 Captives
13 Profile: Ignition Credit
14-15 Profile: HSBC Vehicle Finance
15 Portfolio outsourcing

LAW/REGULATION/TAX

20 Process benchmarking
21 Andy Thompson/Casebook
22 Hire purchase

REVIEW

23 More from *Managing Company Cars, Expert Opinion*

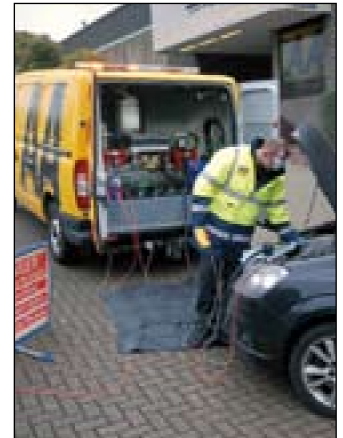
OPINION AND ANALYSIS

24 Peter Cooke
25 Motor Month, Graham Hill
26 Andy Tong, View from the US

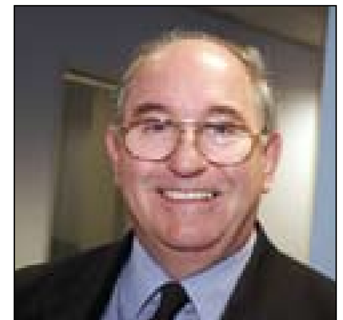
DATABANK

27 Vehicle values

7 LeasePlan financial results



8 AA fleet for Lombard



24 Peter Cooke: knee-sy does it

27 Databank: Used van market undergoing a 'mini boom'

COMPANIES IN THIS ISSUE

ALD Automotive 9
Alphabet 8
Autoquake 6
Banque PSA Finance 5
BMW Financial Services 12
CAP 11
Credit Services Association 4
Finance & Leasing Association 4
Fleet Alliance 9
Fleet Operations 6
Fleet Support Group 8
GE Fleet 6
General Motors 4
GMAC 5, 26
Honda Finance 5
HSBC Vehicle Finance 14
Ignition Credit 13
Inchcape Fleet Solutions 7
LeasePlan 7
Lex 8
Lombard Vehicle Management 6, 8
Red2Black 4
Renault Finance 5
Target Group 15
Volvo Car Finance 5
VW Financial Services 12
Zenith Provecta 8

The road ahead

Dr Roger Gewolb, well-known motor finance industry expert, sets out the future for consumer motor finance in the UK as he sees it, in this wide-ranging and thought-provoking article, assisted by Business Economics Ltd

The writer has repeatedly been asked to give his views on the future and way forward in this never-before market of, essentially, no available car finance, other than absolute "no brainer" super-prime deals.

In the current world economic and financial environment that has developed into a political challenge of the international reserve currency and an inquisition of the entire banking and financial system, its structure, risk profiles and rewards and the breathtaking dislocation all this is causing in all markets and for the citizens of the world, it is impossible to predict anything with accuracy.

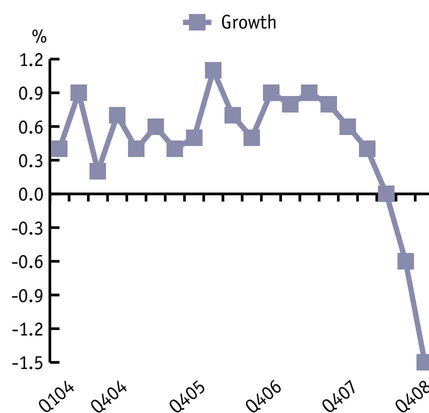
And the current economic news is almost wholly and unremittingly bleak. Perhaps the turning point in public sentiment was the warning from UK chancellor Alistair Darling in an interview with Decca Aitkenhead for *The Guardian* on 30 August 2008 that the economic times faced by Britain and the rest of the world "are arguably the worst they've been in 60 years".

To deepen the sense of gloom, he added: "And I think it's going to be more profound and long-lasting than people thought."

In the pre-Budget report on 24 November 2008, the mood was a little more upbeat with the UK economy predicted to contract in the first half of 2009, but then returning to growth again – with GDP increasing by 1.5 percent to 2.0 percent in 2010.

But it was not long before the IMF weighed in with its forecast, published on January 29 2009, that the UK economy will

Chart 1: Real GDP growth, 2004-08



Source: National Statistics Online, UK Gross Domestic Product, GDP Growth, 19 February 2009

contract by 2.8 percent in 2009 and will grow by just 0.2 percent in 2010. Just in case there was any residual optimism still to be found, the IMF added that this would be the worst performance of any developed nation.

And, in a surprisingly frank speech to a Labour conference on 10 February 2009, cabinet minister Ed Balls appeared to break ranks with the official government line by stating that the current global recession is "the most serious for over 100 years".

While it is hoped that the situation will have improved by the time this article goes to press, the odds would seem to favour what is written here remaining valid. Even if not, the effects on – and damage to – the UK motor and motor finance industries already wrought will not recover overnight.

At the same time, all in our industry would undoubtedly agree that the opportunities created thereby will be substantial and unique as time unfolds. Customers will always need motor cars and the money to finance them, whatever else happens.

Short-term prospects

Turning to the details, Chart 1 shows the official data (as at 19 February 2009) for real GDP growth in the UK economy. It shows that the economy contracted by 1.5 percent in the fourth quarter of 2008, compared with a decrease of 0.6 percent in the third quarter. The deterioration has been rapid, and has accelerated towards the end of 2008.

The deterioration in the economy has been mirrored in the forecasts for the UK economy by independent experts published in January 2009 by HM Treasury. These show that the consensus forecast made in January for GDP growth in 2009 was -2.1 percent whereas, as recently as December, the consensus forecast was only -1.5 percent.

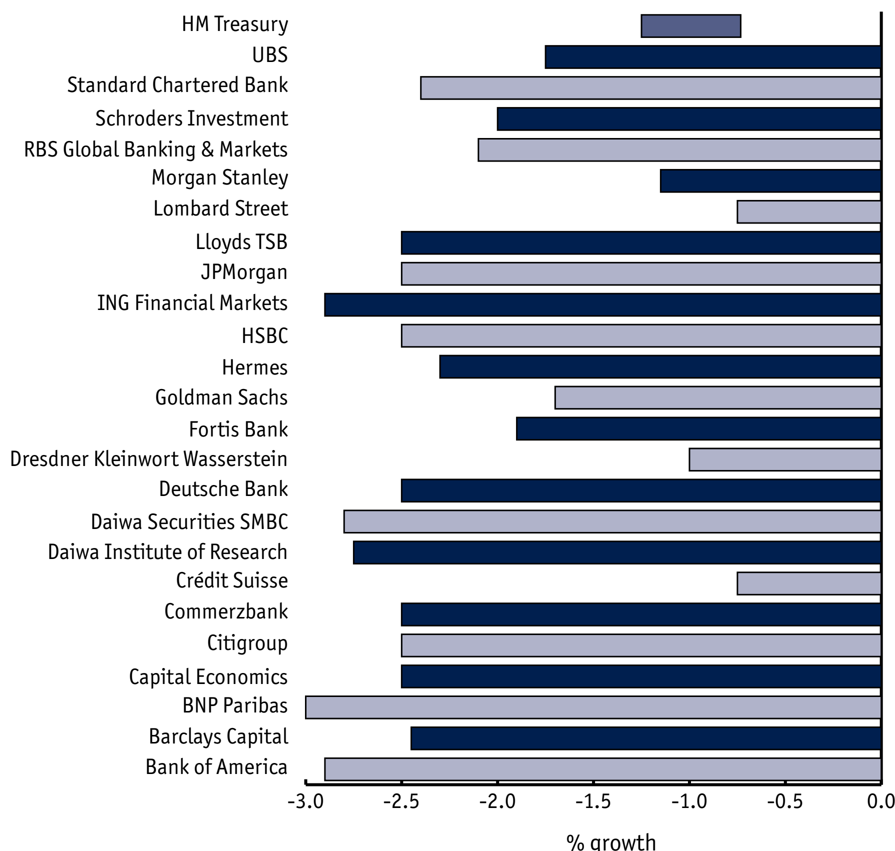
The range of current (January 2009) forecasts for 2009 is shown in Chart 2. As shown in Chart 2, the HM Treasury forecasts published in the November 2008 pre-budget report now look to be optimistic compared with the range of growth expectations issued by the independent forecasters.

The medium-term prospects

Given that we are, without doubt, in a severe recession, the key question is: how long will it last?

If the past is any guide then the omens are not good. There have been four fully-fledged recessions since 1970, each of them associated with a sharp rise in oil prices, a dislocation in the financial markets and a catastrophic collapse in both business and consumer confidence:

Chart 2: GDP forecasts for 2009



Source: *Forecasts for the UK Economy, A comparison of independent forecasts, No 261,* HM Treasury, January 09

The 1973 recession lasted for only three quarters; however, it was followed by a second recession within six months which lasted for four quarters, so in fact seven of the nine quarters between mid 1973-late 1975 were in recession. The 1979-81 recession lasted for seven quarters, and while the 1990-91 recession technically ran for five quarters, it was followed by a further three quarters of exceedingly slow growth.

While some of the more lurid commentary might seem to indicate that we are headed for a new 'Great Depression' like the 1930s, this is likely not the case. Alarmist stories are always present in such times. Our view is based simply on the scale and speed of the global monetary and fiscal stimulus that has been put in place.

To quote the *Spring Markets Commentary* of Fisher Wealth Management: "The contrasts between today and the 1930s are far greater than the similarities. In more instances than not, today is the reverse image of that period fundamentally.

"The only significant commonality is falling equity prices. In the Great Depression, central banks disastrously reduced money, governments raised taxes to balance budgets, and countries fought trade wars. Today's policy actions are overwhelmingly in the right direction, and the size and speed of the global monetary and fiscal stimulus unleashed are unprecedented.

"All this won't abruptly end the recession. Monetary and fiscal stimulus affects the real economy with long lag times, usually 6-24 months. Before banks lend and consumers and companies borrow to spend and invest, the newly created money must flow from somewhere."

Meanwhile, David Blanchflower, member of the Bank of England's Monetary Policy Committee, in a lecture to the University of Nottingham on 29th January 2009 said: "We should bear in mind that the economy will eventually recover. As expectations are revised down there is a danger of becoming unduly pessimistic.

"In the past the UK economy has proved resilient to economic shocks and there is no reason to believe that it won't be resilient in the future."

So what is the overall view? Will the recession be deep? Definitely. Will it be painful? For sure. But will it be different in character from the post-war recessions discussed above? Not in our view. We expect the period of negative growth to be similar

to previous recessions, lasting five to six quarters, and for it to take about three years to regain the pre-recession level of economic output.

The car sector: The impact of recession

All the evidence is that the car market has been hit especially hard, both in the UK and worldwide. The Society of Motor Manufacturers and Traders announced in a letter to the chancellor that UK car production had fallen 58.7 percent to 61,404 vehicles in January 2009 compared with a year earlier. And total car sales in January were 112,087, down 31 percent on the same month last year.

Announcements have already been made of 1,000 redundancies at Jaguar Land Rover, 1,200 at Nissan and 850 at the BMW plant, with more such announcements expected over the forthcoming weeks.

Motor finance

These negative trends have also been seen in their impact on car finance, with many of the significant players reviewing their positions, to say the least:

- Park Motor Finance has stopped writing new business and is in run-off;
- British Credit Trust has also ceased originations or is writing only a trickle;
- The Blue Motor Finance book has ceased and gone into run-off;
- Cattles, far and away our largest non-prime player, issued a profit warning on 20 February 2009 and delayed the release of its annual results pending a review of its arrears and bad debt provisions; having ceased new originations, it now appears to be heading out of existence, although many would say that the credit crunch merely served to accelerate the discovery and effects of what the March 22 edition of *The Sunday Telegraph* called an "alleged accounting fraud";
- Numerous prime players have also stopped writing much business, or certain categories thereof, or tightened up almost to strangulation point.

In a word the car finance market has almost come to dead stop; brokers and dealers are dropping off like flies in a brush fire.

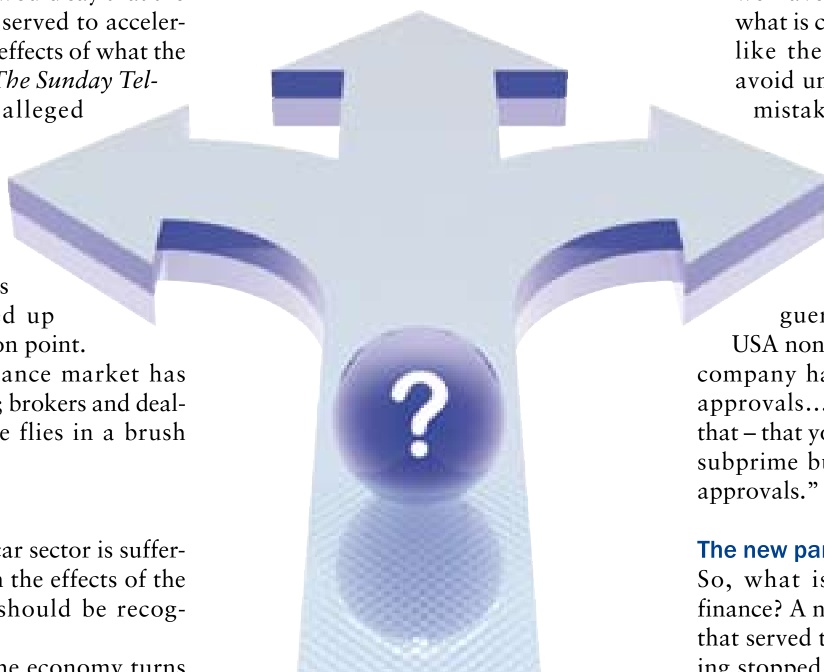
Prospects for the future

While it is clear that the car sector is suffering more than most from the effects of the recession, two factors should be recognised:

- The rebound when the economy turns around should be quite pronounced. This may not just be a case of a return to normality. During the recession, the average car pool will be ageing as owners defer decisions to upgrade to newer vehicles, possibly stimulated by government incentives, as is the case already on the continent. As the economy comes out of recession, there could be a rebound effect on the car market as the pent-up demand for newer vehicles is released;
- Even during the recession, car purchases will continue – although at a much reduced level. For many car users, lifestyle factors require ownership of a reliable vehicle, for example as a means of getting to and from work. Even during a prolonged recession, there will be some requirement for upgrading to a newer, more reliable vehicle; the writer has been through two recessions in this industry in the past (although nothing like what we are currently experiencing, in some respects) and has always noted the marked difference between cars and houses i.e. the motor finance versus the mortgage market – people can rent, live with the in-laws, trade down etc. However, honest, working folk always need a car to get to work and to take families out. No matter what happens, almost everyone always needs a £5,000 car – the backbone of our near-/non-/sub-prime market.

The new business model: Taking stock

With all of the turbulence likely to affect the car finance sector, it is well worth considering the extent to which the established ways of doing business will survive.



We are especially critical of the practices that have led to self-inflicted wounds on the car finance sector, such as the following:

- Over-aggressive advance rates: Lending at 130 percent loan to retail value (LTV), or anything remotely approaching such levels, might in theory have seemed a good idea at the time, but recent developments have highlighted the unsound nature of this scale of lending. The writer now gets to say that his last company, Park, standing mainly on its own amongst the other larger players in the marketplace, always refused to exceed the 100 percent of retail traditional threshold and the quality of its portfolio reflects this admirably.
- Commission wars: Similarly, commission wars that escalate commissions to levels that are unaffordable – and therefore ultimately unsustainable – end up being destructive to the interests of all concerned. Again, from purchase from Hermes in July 2006, the new Park team was able to double turnover, greatly extend average life and increase APRs significantly with only a small, single-digit increase in commissions. Park commissions, as it was widely known in the market, were well below its competitors'; this was achieved through superior service and relationships.
- Auto-scoring: The appeal of auto-scoring is easy to understand: a low-overhead computerised system of assessing proposals which removes the subjective and error-prone nature of human intervention. Unfortunately, while such systems may eventually gain ascendancy, we have seen no evidence so far that what is currently available has anything like the sophistication necessary to avoid uneconomic numbers of serious mistakes – both in terms of acceptances and rejections.

More significantly, the 16 March issue of US publication *Auto Finance News* quotes a senior executive of the now overwhelmingly beleaguered AmeriCredit, the largest USA non-prime player, as follows: "The company has also eliminated automated approvals… We never really bought into that – that you can completely automate the subprime business. Now we do no auto-approvals."

The new paradigm

So, what is the new paradigm for car finance? A number of very good operations that served the market well had their funding stopped dead as part of the process of

systemic deleveraging, i.e. getting rid of loans, being practiced by most banks to get their balance sheets to manageable levels.

This may have been the right move in respect of their mortgage portfolios but was it wrong for cars, were cars just so much smaller a market that they had to go along with all the rest? Who knows?

We set out below our thoughts as to where we think the sector is now heading. Some of the changes that we envisage are long-overdue and are now being driven by the economic necessities of the current business climate. Others are more evolutionary, but no less important as a result.

Firstly, we believe that the car finance sector is based on customer loyalty – in the broadest context; it is totally a people-to-people business.

A car finance company needs good relationships with all of its car purchasers, dealers and brokers. The importance of this interacting web of relationships means that it is difficult to sub-contract key parts of the business without undermining the long-term prospects for good customer service, compliance, arrears management, low bad debts/write offs and repeat business (at all levels) and the solid sustainable growth that comes with it.

Next, we believe that the current "reality check" imposed by the economic situation on commissions, flat rates, and LTVs needs to (and will) become embedded. It will no longer be regarded as a necessity to chase market share if that means destroying the value of the book. In particular, it will no longer be regarded as sensible to chase business by competing ever more aggressively in terms of commissions and loosened underwriting criteria.

In short, as the writer has always pointed out, a lot of big, greedy people who are attracted by the huge spreads and awesome arbitrage that has always existed in UK non-prime motor finance will fall on their faces because they won't get it right and will go too far to outdo each other, rather than rely on a bit of good practice and time to build up solid, hugely profitable long-term relationships.

Finally, we think it is appropriate to question the role of the banks in the brave new world of car finance that we are entering. The profligate lending, proprietary trading and investment policies of some of the major world banks have come in for much justifiable criticism over recent months as being a central cause of the current crisis.

Now also, the lack of lending from the same banks as they try to re-build their balance sheets is subject to equally ferocious criticism. And, in between, the whole question of regulating the banking system, mark-to-market accounting, and the role of the rating agencies is fair game.

But, amid all the turbulence and playing the blame game, the real questions are: will the banks regain an appetite for car finance; and, if so, when?

We do not pretend to have the answers to these questions, but we do speculate that others may well play a more significant role in the future than hitherto.

In fact, it is already more than being mooted that private equity, hedge funds and all manner of alternative investment players will be stepping in and the banks will be left to do what they do best, unimaginative but safe corporate lending and retail banking.

The way forward

Taking all of the above into account, we are optimistic about the eventual future prospects of the consumer car finance market in the UK. Indeed, we believe that there are significant opportunities, especially right now, given:

- The withdrawal of previous major players' funding (mainly as a knee-jerk adjunct to closure of mortgage lending) and the curtailment of the lending operations of almost all others;
- The return of demand when (as it undoubtedly one day will) the economy begins to come out of recession.

However, whether or not there is worse to come, we do not believe that car finance will emerge unaltered by the crisis and, as set out above, our view is that the adoption of new business practices will be essential for the successful players of the future.

In our view, these new players will arise both from consolidation and new-start businesses:

- Consolidation: Since the onset of the credit crisis, there have been two waves of interest in transaction-related activity. Initially, interest was focused on the acquisition of non-prime lending businesses that were impacted by the credit crisis, but where the management team and strategy were basically sound. As the crisis has deepened, however, the focus has moved towards interest in the purchase of asset books rather than businesses.
- New start businesses: We also think that there are opportunities for low-start scalable ventures that set up a modest lending venture in order to acquire a presence in the market (especially in terms of reactivating relationships with brokers and dealers – and saving some from closure) and a platform to be well-placed to take advantage of the upturn that will inevitably occur.

There is no doubt that the next months will be grim for the sector. But in the medium term, we remain optimistic that car finance will return to being a profitable business (and non-prime even more so) with solid growth prospects. But the landscape will have changed and only those parts of the sector willing to move with the times will reap the rewards for their patience, experience and vision.

The author will be delighted to exchange views at roger@gewolb.com