Executive Insights

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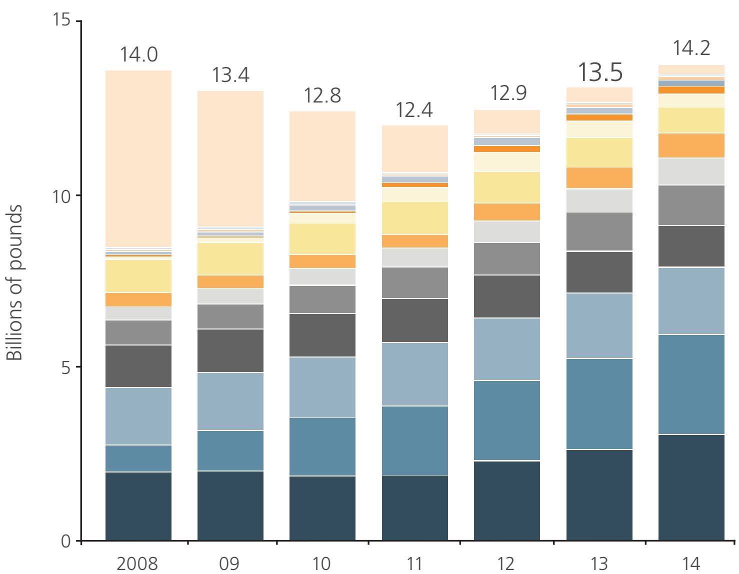
Consumer Specialist Lending: Newly Sustainable or Another Boom-and-Bust?

After falling out of favor following the 2007 economic downturn, U.K. non-prime consumer specialist lenders — providers of loans for individuals ineligible for traditional bank financing — have rebounded strongly over the last few years.

Lending balances have returned to growth and recent multiples paid in sector M&A activity demonstrate market confidence to the extent in which this sector can continue to grow (see Figure 1). However, with its checkered history and some problems re-emerging in the U.S., some are legitimately questioning whether the industry is once again growing beyond its means and how

Figure 1

U.K. outstanding unsecured non-standard loan balance, by product



	CAGR% 2008-11	CAGR% 11-14
Total	**(4.1)**	**4.6**
Inactive unsecured	(35.6)	(41.0)
Logbook loans	0.3	13.6
Branch-based lenders	14.0	37.5
Pawnbroking	18.1	(1.5)
Guarantor loans	36.4	21.4
Payday loans	75.5	(2.8)
Home collected credit	(0.6)	(7.5)
Car finance	0.8	20.8
Rent to buy	10.8	12.6
Credit cards	9.3	8.0
Store cards	(0.4)	(0.6)
Mail order credit	4.5	1.2
Point of sale loans	35.4	13.2
Sub-prime credit cards	(1.6)	17.3

Source: L.E.K. analysis

Consumer Specialist Lending: Newly Sustainable or Another Boom-and-Bust? was written by **Ashish Khanna** and **Peter Ward**, partners in L.E.K. Consulting's Financial Services practice. Ashish and Peter are based in London.

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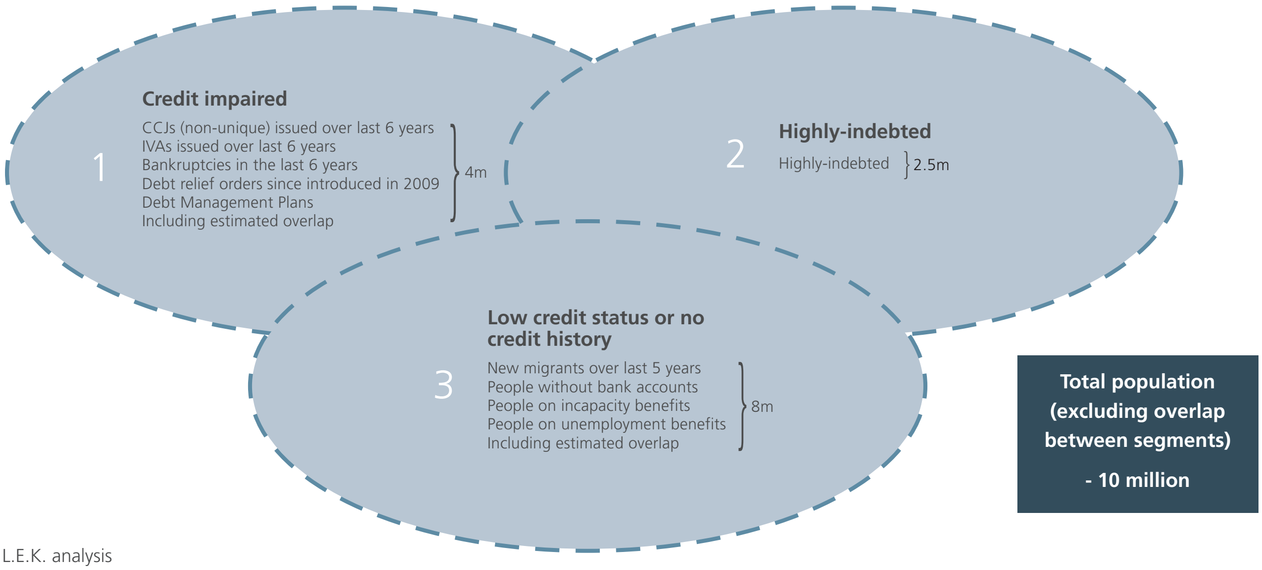
Figure 2
U.K. non-standard adult borrower population (2015)



Source: L.E.K. analysis

companies and investors can mitigate the risks of participation. The U.K. is at the global forefront of development in non-standard lending – but is this leading edge or the bleeding edge?

Specialist lending is more than just a niche for adventurous investors or, as some political and other commentators might have it, some kind of morally dubious back-street industry. The sector addresses the estimated 20% of adult borrowers in the U.K. — some 10 million, according to L.E.K. research — deemed "non-standard" by mainstream lenders, a proportion that is similar in other developed countries. As well as those who are over-indebted, these individuals include young or first-time borrowers or those who are new to the country and consequently have little to no credit history, and those with moderately or more seriously impaired credit history (see Figure 2). This group also contains a significant number of individuals who would have been considered prime risks prior to the crisis, but are now deemed non-standard, such as the self-employed.

A redefined market attracting investment

Non-standard lending has changed dramatically since the onset of the crisis in several important respects.

Firstly, regulation in the U.K. is now much tighter, especially since the arrival of the FCA as the new regulator for consumer lending. The FCA has focused on product suitability, Treating Customers Fairly (TCF), affordability, forbearance, interest rate caps (in some instances) and, more generally, a far more pro-active and interventionist approach, albeit that some industry participants expect interventionism to soften somewhat following recent leadership changes. This has had far-reaching consequences for business models and, in some cases, profitability and even the very survival of particular parts of the industry, most notably payday lending. Many of these themes are also playing out across Europe, as regulators awaken to the nuances of how customers interact with these businesses.

Secondly, the disappearance of wholesale funding post-crisis helped to thin the ranks of this once-crowded specialist field. These were replaced by a cadre of largely mono-line providers returning to first principles in a relatively uncompeted environment, focusing on much more disciplined underwriting practices and a renewed focus on treating customers well. The historical tendency of some players to treat non-standard customers poorly has been replaced by a virtuous circle of improved customer management and relationships, which can ultimately result in lower loan defaults, multi-product and /or repeat borrowing relationships and higher profitability for lenders.

Thirdly, the pace of innovation has accelerated, both in terms of product design and distribution, often supported by technology. In product design, new ideas such as the use of guarantors for guarantor loans, the use of starter-interrupter technology in motor finance and the more sophisticated use of data in underwriting have all widened the scope of how customer needs can be met. In distribution, customer preferences have changed: the use of classic brokers has declined as online distribution has grown and become more sophisticated, targeted online and above-the-line advertising has developed, and regulatory intervention has challenged the economics of smaller brokers. Technology is now also at the heart of most operational processes.

Figure 3
The virtuous circle of improved customer service in specialist lending

Source: L.E.K. analysis

As a result, there has been an increase in the number of investors seeking to fill the void. Trade player such as

Non-Standard Finance plc, International Personal Finance and Provident Financial have all demonstrated an active interest in acquiring broader product capabilities. A range of other PE funds, including those who have not participated in the sector historically, are also being attracted to the sector by the high returns promised by the valuations achieved in recent sales processes.

Another question often on the lips of industry participants is when and how high-street banks might re-enter the fray. Some larger institutions have begun funding lenders offering non-standard loan products but, on balance, L.E.K. considers it unlikely that high-street firms will wish to underwrite such loans themselves, even over the medium term (and are unlikely to move beyond near-prime when and if they do). This is principally a result of the higher capital thresholds imposed on banks under Basel III and risk aversion driven by regulatory and government intervention. It is still a brave employee that walks into the boardroom of a major high-street bank and suggests starting a sub-prime lending business not least for these reasons, but also because the capability that once wrote this business in-house left the building long ago – a fundamental re-start would be required. These considerations are likely to keep high-street banks' lending standards tight.

Overall, even with improving macro-economic fundamentals and recent recovery, specialist lending supply remains well below consumer demand with most lenders having application conversion rates of under 10%. This leaves ample room for qualified newcomers to join the fray and for current participants to invest further, as long as they can create propositions that recognize the risks of participating in this segment.

Strategies for successful participation

Despite the many positives, participants and their investors must maintain a measured approach to operate profitably in this complex sector. L.E.K. considers the following ingredients integral to specialist lending success:

1. Treat customers well and fairly.
The age of predatory lending practices and product-centric profiteering is over. The most enlightened lenders have always known this and have behaved accordingly, but it is now essential for everyone. This isn't just a regulatory issue, it's also good business: customers who are treated well are more likely to remain loyal to the lender, and may establish broader and longer relationships.

2. Maintain underwriting discipline.
In a competitive environment that includes significant participation in the online environment, the easiest way to gain market share is to loosen underwriting criteria and compete on price. However, this is a high risk strategy and getting it wrong would fundamentally challenge the economics of the business over anything other than the very short term. Technology and data do allow for innovative approaches to be developed that maintain underwriting standards, for example, by supporting better borrower profiling and improved product design.

3. Really understand customers' needs.
Managing the high cost of customer acquisitions resulting from underwriting complexity for this customer group remains one of the lead challenges for specialist lenders. Spreading this expense across additional products and services (i.e., broadening out from a mono-line product approach or highly specific focus in the credit spectrum), can help transform the economics. A detailed understanding of customer needs and behaviors, starting with knowledge of current product cross-holdings within specialist lending and extending to understanding the full customer lifetime journeys as they navigate their finances up and down the credit spectrum over time, is increasingly important. In both cases — latitudinal and longitudinal extension of customer relationships — customers will meet their borrowing needs somewhere and the winning players will achieve a higher share of overall wallet by focusing on the specific areas in which their core capabilities enable them to excel. Smart use of technology, data and continued

innovation to keep finding new ways to satisfy customer needs all have key roles.

4. Work pro-actively with the regulator.
Lenders must focus on fostering a pro-active relationship with the regulator, keeping up to date with requirements as well as providing full transparency into lending practices and product specifications. For the minority of players who historically "kept quiet and hoped the regulator wouldn't notice", the tide has turned. Agreeing innovations ahead of time and complying with the spirit as well as the letter of the law is essential, especially given the retroactive nature of regulatory oversight and the consequent legacy risks which may arise.

Maintaining a disciplined approach

Having moved beyond its past failings, specialist lending continues to experience strong consumer demand, and in the estimation of L.E.K., it is in the midst of a prolonged period of growth. With high street lending standards remaining rigid, nearly a quarter of the U.K. adult population — including customers who may have once qualified for a conventional loan — are still turning to specialist lenders and will continue to do so and their need is growing.

Specialist lenders and their investors can certainly win, but only with the right approach, systems, discipline and knowledge. To ensure ongoing stability, current as well as incoming players must maintain a responsible approach to lending, work pro-actively with the regulator and keep investing in enhancing customer relationships, including via data, technology and broader innovation. For their part, funders must ensure that they are backing truly sustainable business models.

Regulators also need to continue keeping a close eye on the industry to ensure that past excesses do not return, and equally to recognize that a collaborative approach between all parties will be the best way to achieve fair and positive outcomes for all constituencies in the market.

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