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Focus on specialty finance

An introduction to European consumer credit

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European consumer credit is one of the largest and most diverse loan asset classes in Europe. It has also had resilient performance through economic cycles.

In this paper, we investigate why we expect this trend to continue and also outline why investors, who have traditionally been unable to acquire exposure to this asset class, are now able to do so.

We believe that the confluence of a positive outlook and increased availability makes exposure to consumer credit in Europe a compelling opportunity for investors investing in private or alternative credit opportunities.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, please note that this is not a guide to future performance

The importance of consumer credit in a well-functioning economy

Governments borrow money to support their spending priorities, and businesses do so to fund growth, optimise their capital structure and manage their working capital. Individuals (consumers) borrow too and for very similar reasons. They may take out multiple different types of loans at different points in their lives for specific purposes. In general, young people borrow to finance higher education and training programmes to improve their employment and earnings prospects (student loans).

As they enter the workforce and their earnings power rises, they start repaying their student loans and instead borrow to support their own evolving lifestyle needs and those of their family – they may take out an auto loan to buy a vehicle, credit cards, personal loans and point-of-sale finance for day-to-day spending and purchases. And, finally, as people get older, many eventually take out a residential mortgage loan to buy a home.

Almost every consumer takes out at least one of these types of loans during their lifetime; most take on several; some take on all. Depending on the specifics of each loan type, borrowers typically repay loans in manageable instalments over time from their savings and earnings.

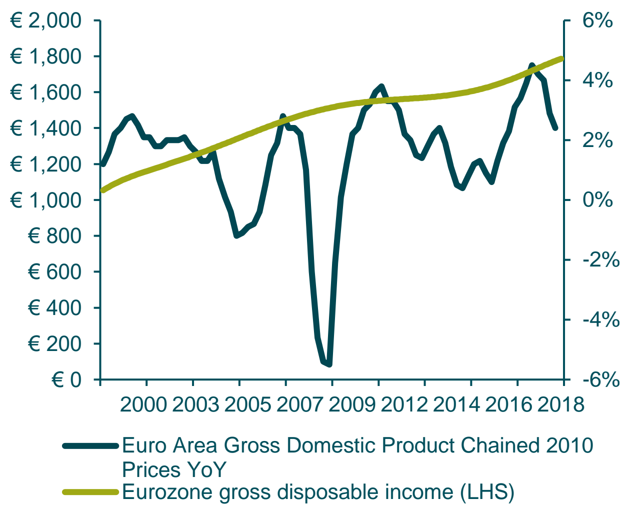
The ability of consumers to borrow and repay in this way across different types of consumer loans is central to the way an economy operates, grows and develops, especially with consumer spending being a key part of GDP of most developed economies, including Europe and the US.

Governments and policymakers in these economies therefore have a vested interest in ensuring the orderly functioning of consumer credit markets. This means ensuring the availability of prudent, fairly priced and affordable credit options for consumers, at all times.

The resilience of consumer credit

Consumer loans have shown capacity for resilience despite headwinds over the past 15 years. Regulators in both the US and Europe have made the loans safer and stronger by imposing new rules on lenders post-crisis, effectively making it harder for consumers to borrow to unsustainable levels in the event of an economic downturn. It is worth noting that consumer credit, owing to its homogenous nature, can be far more easily regulated and harmonised compared to corporate lending (whether through loan markets or bond markets).

Figure 1. Euro area household disposable income (LHS, in €) and GDP growth rate (RHS, in %)



Source: Bloomberg

Controls on consumer lending, such as rules on affordability assessments performed by lenders, bank capital requirements for consumer loans, stress-testing of consumer credit portfolios, among other controls, are relatively easy to implement and have been in recent years.

In contrast to corporate credit, consumer credit may therefore stand out as being much more tightly controlled compared to pre-crisis times. This close regulatory attention is obviously attractive to lenders, and by extension, to investors in consumer credit portfolios as well, provided they earn an attractive return to compensate for the risk.

Credit risk-adjusted margins are attractive for European consumer credit

Against a backdrop of improving household finances in Europe (see Figure 1), consumer loan margins, particularly in contrast to corporate loan margins, have remained attractive, as can be seen in Figure 2. Importantly, supportive factors, both at a micro and macro level, augur well for this trend to continue.

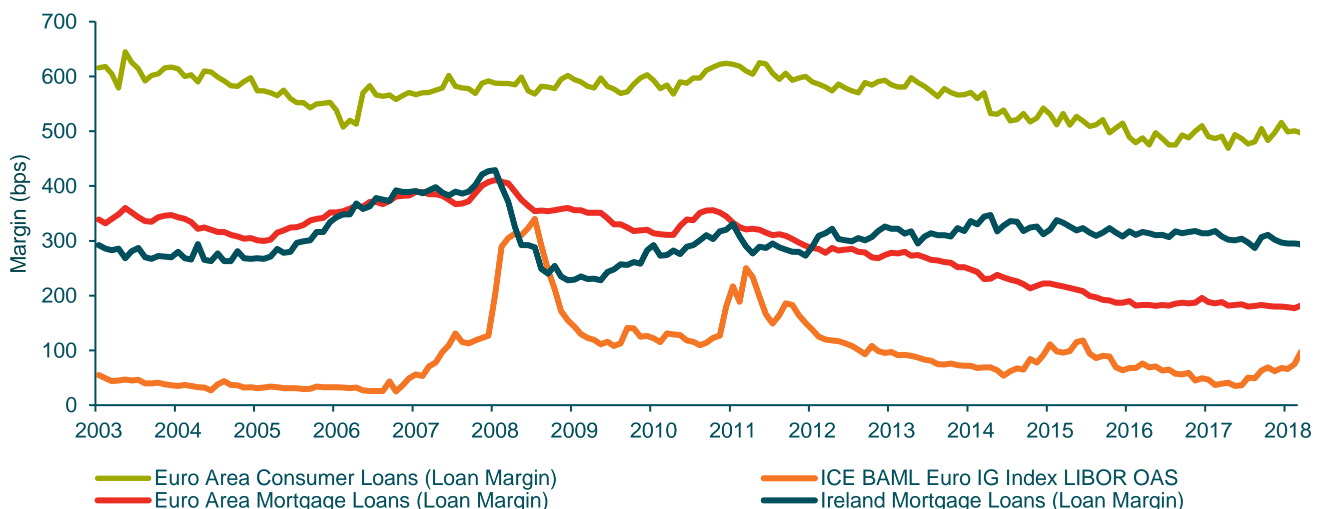
Factors supporting the positive outlook for consumer credit in Europe

Beyond the importance of micro factors, such as strict controls on ‘affordable’ lending, the full-recourse nature of consumer lending (which fosters a responsible attitude towards credit) and bank capital rules that penalise high risk lending activities, the macroeconomic environment is also supportive for the outlook for consumer credit.

Monetary policy in Europe is very accommodative and inflation remains subdued, which has enabled absolute rates (if not loan margins) to come down (with the low cost of borrowing supportive of credit performance). Central banks, most notably the ECB, have indicated their willingness to keep interest rates at current lows and to further lower rates, if necessary, to help boost economic growth.

There are also calls for increased government spending in several countries in Europe, which can help to support labour markets and real wage growth. While GDP growth and corporate profitability matter to businesses and to stock market returns, and draw considerable attention

Figure 2. Euro area consumer loan lending margins are high and stable



Source: ICE BofAML indices Euro IG Index LIOBOR OAS (Ref. ER00), as at 31 March 2019 LIBOR OAS was 76. Euro area loan and rate data available from ECB Statistical Data Warehouse.

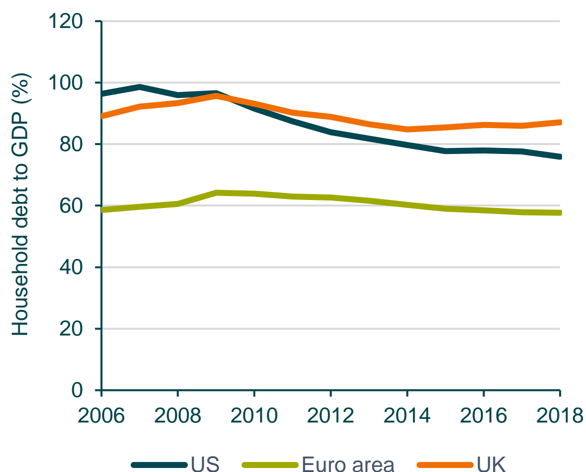
each quarter, consumer credit performance is largely driven by unemployment rates and household income trends. The macro environment may also influence demand for the different types of loans – consumers who are looking to purchase a property may use low rates and positive employment prospects to trigger their decision in the short term, for instance.

Accommodative monetary policy and fiscal stimulus measures are both positive for consumers, and create conditions that therefore enhance consumers' ability to service their debt.

In depth: Consumer credit – a US and European comparison

The rise of non-financial corporate debt in the US since the crisis, particularly leveraged corporate debt, and the risks it poses, is well documented by several sources. By contrast, US households have shown tremendous borrowing discipline and, on most measures, have deleveraged since the crisis. The good US consumer debt landscape can serve as a point of reference to also evaluate the position of European (Euro area and UK) households in the same time period.

Figure 3. Household debt-to-GDP ratio (in %)

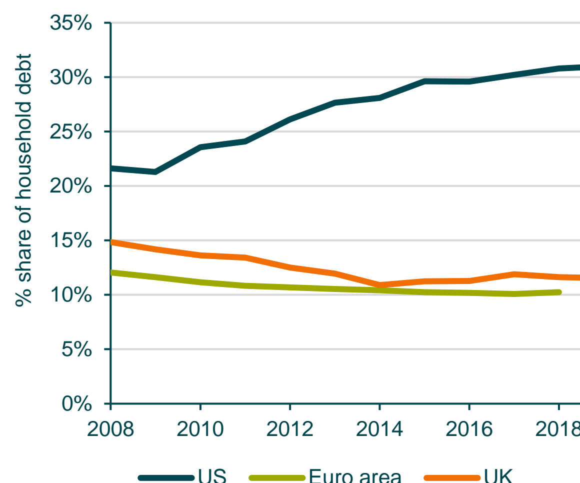


Source: Bank of International Settlements, as at 31 December 2018.

As can be seen from Figure 3, Euro area households have been consistently less indebted than US households. UK households, in turn, appear to be the most leveraged out of the three, but a closer look at the split between mortgage and non-mortgage debt highlights some key differences (see Figure 4).

Since the crisis in 2008, US households deleveraged in aggregate, but the focus of this deleveraging was on mortgages. Non-mortgage consumer debt (credit cards, personal loans, auto loans and student loans), however notably rose from c.20% to over 30% of total household debt. The picture in Europe couldn't be more different to the US in that respect. In Europe, the share of non-mortgage consumer debt (which has always been and remains far lower than in the US at approximately 12%) actually decreased post-crisis and remains comfortably less than half the level of the US. This is important since mortgage borrowing has traditionally been the safest form of consumer debt and has been available to the most creditworthy consumers. Indeed, rules for mortgage provision have tightened significantly since the crisis both through regulation and through bank capital rules.

Figure 4. Non-mortgage consumer debt as a share of total household debt (in %)



Source: M&G calculations based on OECD data, as at 31 December 2018.

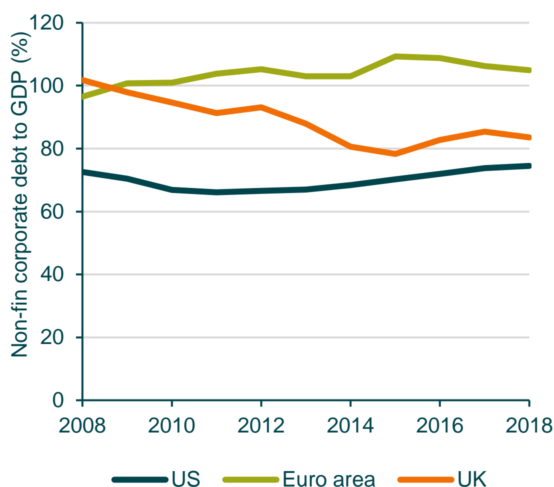
In our view, what drove the reduction in mortgage debt in the US was the extinguishment of debt (which occurred through defaults) as well as reduced new lending in subprime mortgages, which, as is well known by now, was a big part of the US mortgage market leading up to the crisis. The reduction in US mortgage debt stock in the five years since 2008 (equating to a 11% reduction) and a commensurate increase since 2013 – to leave the overall stock over this 10-year period, roughly unchanged – is illustrative of that. Europe, on the other hand, did not have a meaningful subprime lending sector even pre-crisis, and mortgage debt performed admirably even through the crisis (with some limited exceptions); therefore, mortgage debt trends have remained stable. The UK has seen total mortgage lending increase since the crisis, reflecting population demands and a societal shift towards

home ownership; however, performance continues to remain strong.

A typical comparison of debt dynamics across countries focuses on four sectors: households, non-financial businesses, financial sector and government. We have already discussed household sectors in all three regions. Figure 5 shows a cross-regional comparison of the non-financial business sector – the comparisons are not too insightful other than that the UK non-financial corporate sector has deleveraged post crisis.

Hidden by this otherwise stable trend of non-financial business sector leverage, the inexorable rise of leveraged corporate credit in the US is a potential risk hotspot to watch, in our view.

Figure 5. Non-financial corporate debt-to-GDP ratio (in %)



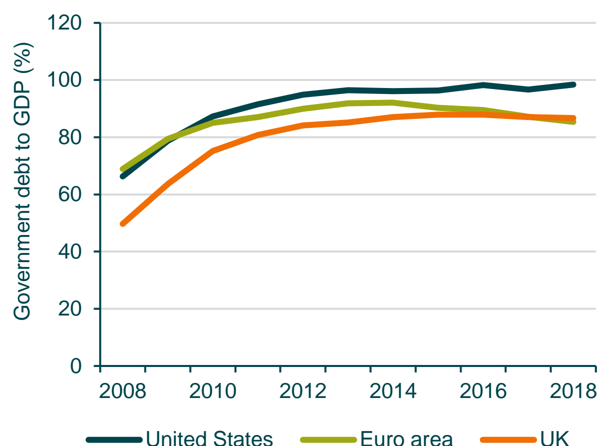
Source: Bank of International Settlements, as at 31 December 2018.

Looking at government debt, the differences in the US and Europe are again apparent (see Figure 6). While all three regions (US, Euro area and the UK) experienced a rise in government debt ratios in the past decade, it is only the US where the trend has continued to be towards higher debt.

The US not only has the highest debt-to-GDP ratio but also has shown limited willingness (or ability) to control its debt burden. Europe, on the other hand, has shown fiscal restraint.

The gap between the US and Europe on this metric presents an opportunity for European governments to increase government spending, which has positive implications for consumers (increased incomes and improved employment prospects), all of which are positives for the performance of consumer credit.

Figure 6. Government debt-to-GDP ratio (in %)



Source: Bank of International Settlements, as at 31 December 2018.

Why can investors access consumer credit in Europe now?

Banks in Europe have been severely challenged since the financial crisis on several fronts, but particularly in light of increased capital requirements from Basel III (and Basel IV still to come), very low interest rates, increased regulatory costs and higher technology spending to compete with the emergence of fintech and non-bank lending platforms – all the while being unable to generate sufficient earnings to balance these requirements. European banks, on average, trade below book value and are forced to think about shrinking the size of their balance sheets as a way to improve their capital position.

Furthermore, Europe's banking sector is also significantly larger than the US relative to GDP – bank balance sheet to GDP ratio in the US is around 80%, while in Europe it is between 200% and 400%, depending on the country – and capital markets (and non-bank lenders) are much smaller. So, borrowers in Europe still rely on banks for their borrowing requirements, but banks can only ensure they have the capacity to do more lending by selling some loans to non-bank partners.

US banks tend to be well-capitalised and quite profitable in comparison to the banks in Europe, which has allowed them to adjust to higher capital requirements and cost pressures through retained earnings without needing to deleverage, leading to fewer opportunities to acquire core US banking consumer loans. Non-bank lenders, with access to capital markets for equity and debt capital, are also a bigger part of the US landscape and, apart

from marketplace lenders, do not generally sell consumer credit portfolios to credit investors.

Given these structural shifts in the European banking landscape, many European banks recognise the need to pursue a more sustainable long-term business model. What that means for many is that if they still want to lend to their core customers and continue to retain these relationships over the long term, they have to develop partnerships with institutional investors to whom they can sell some of their core loan assets on a regular basis. For retail banks, in particular, this is a key area of focus: consumer credit makes up the biggest part of the balance sheet (up to 70% to 80% of retail bank loan books). This changing landscape can therefore be to the benefit of all involved:

- Qualifying European consumers can access affordable credit from banks;
- Banks can continue to serve their customers by having the capacity to lend to them; and
- Investors can diversify their investment portfolios by acquiring exposure to performing consumer credit assets.

Ironically, investors acquiring consumer credit portfolios from European banks are helped by European banks to finance these portfolios cost effectively. This is because, while banks are constrained on capital, they have surplus liquidity, which attracts very low (even negative) interest rates if left with the central banks. So, banks are often keen to finance buyers of performing consumer loans and earn some income in the process, while keeping risk low. Buyers that acquire consumer loan portfolios can therefore get cost-effective term financing on such portfolios from European banks (or through the term asset-backed securities (ABS) markets).

A growing role for consumer credit in institutional portfolios

As we have discussed above, a positive confluence of several factors supports the case for European consumer credit as an attractive asset class for investors and underpin the case for making an allocation to them as a part of a diversified investment portfolio.

- Loan-specific constraints and controls imposed by European regulators;
- Restrictive capital rules and deleveraging impulse of European banks;
- Improved outlook for household earnings;
- Low absolute interest rates;
- Accommodative monetary policies in Europe; and
- Prospect of more fiscal spending by European governments to stimulate growth.

We believe this combination of supportive factors, which is specific to Europe, makes European consumer credit one of the most exciting opportunities in private credit.

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