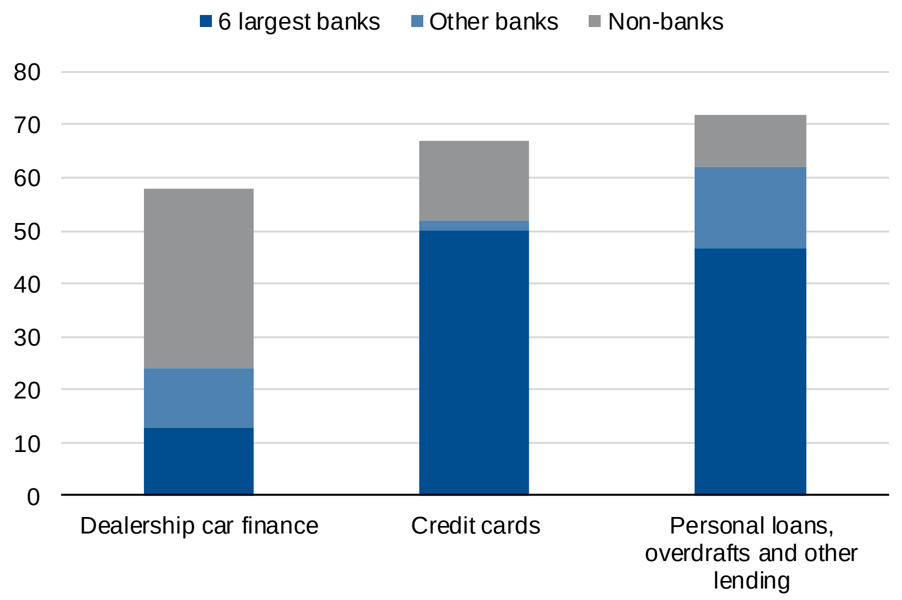
Focus on UK Banks' Consumer Finance Exposures

Since its June 2017 Financial Stability Report, the Bank of England has highlighted the rapid growth in consumer credit as a "pocket of risk", with lenders overall judged to be "underestimating the losses they could incur in a downturn". For the largest banks, asset quality metrics remain strong supported by the current benign employment situation and low interest rates. However, it is the less easily measurable factors such risk appetite and pricing behavior which may be better indicators of future credit losses. Consequently, Scope views positively the proactive measures being taken by UK regulators as they should prompt all lenders to better position themselves against potential losses.

On 25 September 2017, the Financial Policy Committee (FPC) communicated that based on the very deep recession captured in the 2017 annual stress test scenario, the UK banking system would incur UK consumer credit losses of around GBP 30bn in the first three years, representing 20% of UK consumer credit loans and 150 bps of the aggregate CET1 capital ratio of the UK banking system1. Under the scenario, impairment rates were around 25% in credit cards, 15% in personal loans and 10% in car finance.

As shown below, smaller banks are material providers of personal loans. As a matter of fact, the FPC has highlighted that smaller banks have increased consumer lending by 14% in the past year, above the 9.8% rate for the market.

Figure 1: Breakdown of consumer credit (GBP bn)



Note: Six largest banks defined as Barclays, HSBC, Lloyds, Nationwide, RBS and Santander UK.
Source: Bank of England, Scope Ratings estimates

The FPC has also highlighted the increase in lending to higher-risk segments, and the reduction in margins and risk weights for consumer loans. For the largest banks, asset quality metrics for personal loans currently do not cause concern, with NPL ratios in the 1.5% to 4% range. However, it is the less easily measurable factors such risk appetite and pricing behaviour which may be better indicators of future credit losses.

[1] For the major banks, the aggregate CET1 capital ratio stands at 14.3%.

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For this reason, we view positively the measures being taken by UK regulators. These include:

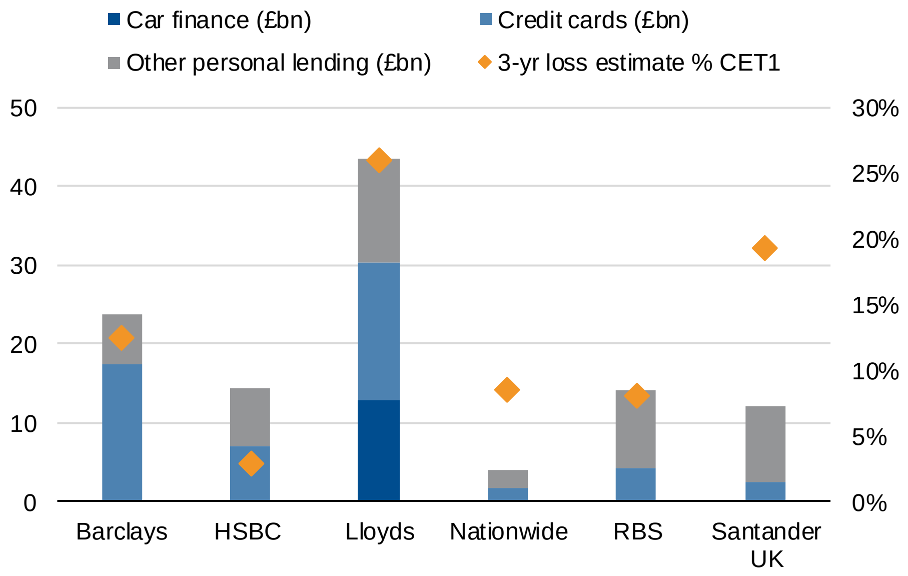
- Raising awareness of the issue;
- Asking banks to justify how they are not placing too much weight on recent performance in assessing creditworthiness. In addition, in the first half of 2018, final rules and guidance on how banks assess creditworthiness will be published;
- Communicating their expectations to banks to start factoring in the market-wide levels of stress losses in consumer credit into their overall lending and capital plans;
- Subjecting smaller banks with material consumer credit exposure to the stress scenario and incorporating the results into their capital assessments; and
- Increasing the UK countercyclical capital buffer rate to 1% from 0.5%.

Individual bank exposures reflect business models

When looking at the consumer finance exposures of the individual banks, Scope does not find the results to be overly surprising as they reflect the banks' business models and market positioning. For example, credit cards have been a core business for Barclays for many years, not only in the UK but also the US. Meanwhile, Nationwide as a building society focuses on its primary role of providing mortgage financing for its members.

Lloyds' large exposure reflects the group's leading position in the retail market. For Santander UK, we point out that the 3-year loss estimate appears to account for a high proportion of CET1 capital but that the bank is also part of a larger and strong group, Banco Santander.

Figure 2: Estimated consumer finance exposures (GBP bn) and potential losses



Note: 3-year loss estimates based on Bank of England loss rates of 25% for credit cards, 15% for personal loans and 10% for car finance.

Source: Company data, Scope Ratings estimates

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