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PwC analysis of consumer lending in Canada and what it means for banks

After the recession: What's next for consumer lending in Canada?

Executive Summary

We've all seen the headlines: "Mortgage Debt Tops $1 trillion" [1]; "Curb your enthusiasm for debt – Mark Carney [2]"; "Excessive personal debt a concern [3]". PwC's consumer lending survey findings show that the financial crisis has left consumers more risk averse, cost constrained and conscious of their debt loads. In this new landscape, how can Canadian banks continue to grow their consumer lending business? **What's next for Consumer Lending in Canada?**

PwC's survey of over 600 Canadians, homeowners with incomes over $100,000, conducted by Leger Marketing, reveals that the majority of survey respondents plan on acting on their current debt levels in the next 12 months. 64% are planning to reduce their debt in the next year. They are less willing to take on additional credit despite confidence their banks can provide them with more. In order to reduce debt, they intend to cut back on discretionary spending. And they are looking for more advice when it comes to credit management. Consumer lending drives a significant portion of retail banking profitability. In order to continue to sustain top-line growth, banks will need to increase the proportion of a customer's borrowing, keep their existing customers longer and, wherever possible, try to acquire new customers.

76% of customers "always shop around" for credit, although a similar proportion of customers start with their primary financial institution. From this, it seems that customers shop around to ensure that they are receiving an appropriate rate from their primary bank.

Lastly, many lending products have a fixed term, requiring new loans or refinancing at the end of each term—practically forcing your customers to shop around for the best offer. Evergreen lending products, based on a home equity line of credit, but with additional flexibility, can help to reduce credit risk while increasing duration of the loans.

Banks are introducing new products to help consumers, while reducing their own risks and increasing volumes. Integrated lending products are one of the most popular new concepts; but while many banks have tried to gain traction in the marketplace, few have really succeeded. According to the survey respondents, the majority find consolidated lending products appealing, and most are looking for education about how this product can best work to fit their unique needs. To successfully market consolidated lending products, bankers need to understand their clients' needs and tune the many detailed product features to each customer's unique circumstances. Listening to and understanding customer needs is critical.

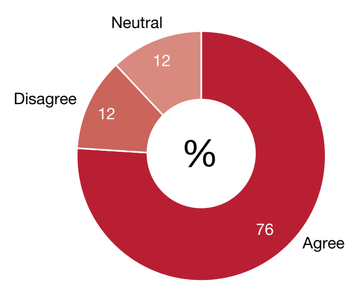
Introducing these new products will likely require transformational change programs at the banks to create new products, and new sales and servicing capabilities. In this document, we summarize the survey results, share insights into successful tactics and behaviours we've seen in the industry, and offer ideas which could help banks achieve their financial objectives and differentiate themselves in the marketplace.

1 CBC.com, November 8, 2010, retrieved November 24, 2010
2 The Globe and Mail, September 30, 2010, retrieved November 24, 2010
3 The Globe and Mail, October 20, 2010, retrieved November 24, 2010

Drowning in debt? How do Canadians feel about their current levels of debt?

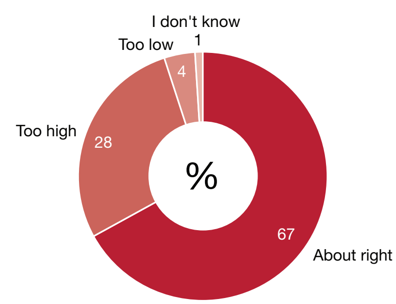
According to the survey, debt isn't a particularly scary word to the majority of Canadians. Nearly 80% agree that borrowing money is necessary to maintain their household.

Figure 1: To what extent do you agree with the following statement: "I believe borrowing money is necessary."



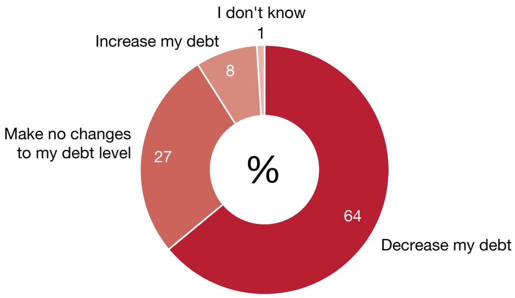
Additionally, 67% are comfortable with their borrowing.

Figure 2: Do you feel your current level of debt is...?



Regardless, most (64%) intend to decrease their borrowing over the next 12 months.

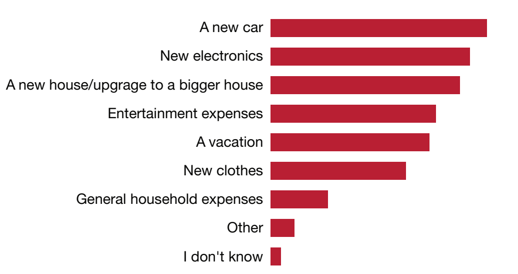
Figure 3: In the next 12 months, I have plans to:



While the consumers polled in this survey may be generally comfortable with their debt, Bank of Canada Governor Mark Carney warned Canadians in December 2010 to curb their enthusiasm for debt. Using particularly strong language, Mr. Carney said that the ratio of household debt to disposable income hit 148% in the third quarter of the year, a new record and a level that surpasses that of the US for the first time in 12 years. “This cannot continue,” he warned, adding that while the net worth of Canadians is about six times the level of average disposable income, asset prices rise and fall but “debt endures.” And despite the buoyancy of the real estate market, the debt-to-asset ratio among Canadian households is at its highest in more than two decades.

So, what is the primary motivator for Canadians to reduce their debt? The fear of not being able to pay off their debt if it gets too high, followed by the economy and job security. Widespread media coverage of potentially rising interest rates, personal bankruptcies, job losses and big government deficits could be the reasons behind this motivation.

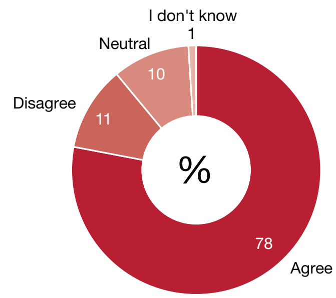
Figure 4: In order to reduce debt, what purchases would you be most willing to delay?



To reduce debt, consumers are willing to defer spending on big ticket items such as: car, electronics, a new house or home improvement, entertainment expenses, followed by vacations. Those that feel stretched now realize that with rising interest rates they will inevitably feel more stretched as rates continue to rise.

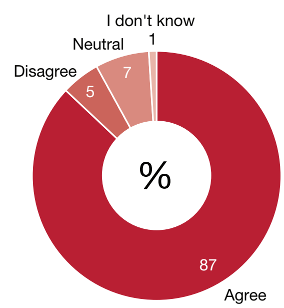
Surprisingly, 78% of respondents still believe they have the capacity to borrow more.

Figure 5: To what extent do you agree with the following statement: “I believe I have the capacity to responsibly borrow more.”



Almost 9 in 10 agree their bank is willing to offer them additional credit.

Figure 6: To what extent do you agree with the following statement: “I think my bank is willing to offer me the credit I need.”



So, if the majority of consumers plan to reduce their debt, what do banks need to do to continue to increase profitability in their consumer lending portfolios?

1. **Grow “share of wallet” for their existing customers**, and

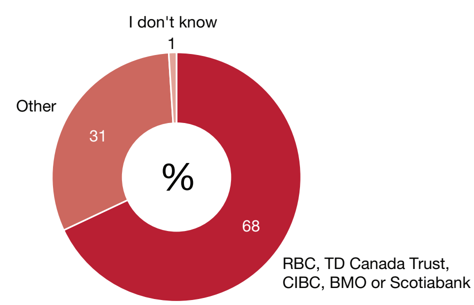
2. Acquire new customers.

With service, comes satisfaction

How satisfied are Canadians with the level of service they receive from their bank?

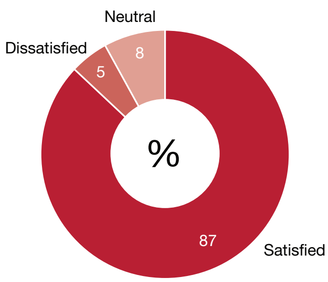
The success story of Canadian banks' performance among its global counterparts has not waned in the post-recession landscape—and neither has customers' confidence in their banks. Nearly 70% of respondents continue to use one of the Big 5 banks for their daily banking needs.

Figure 7: Select the primary bank you use for your daily banking needs.



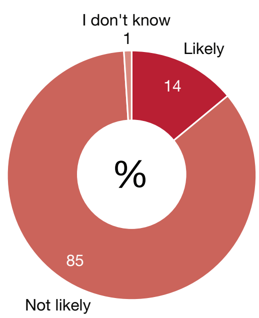
87% of respondents are satisfied with the service they receive from their primary bank.

Figure 8: Overall, how satisfied are you with the service you receive from your primary bank?



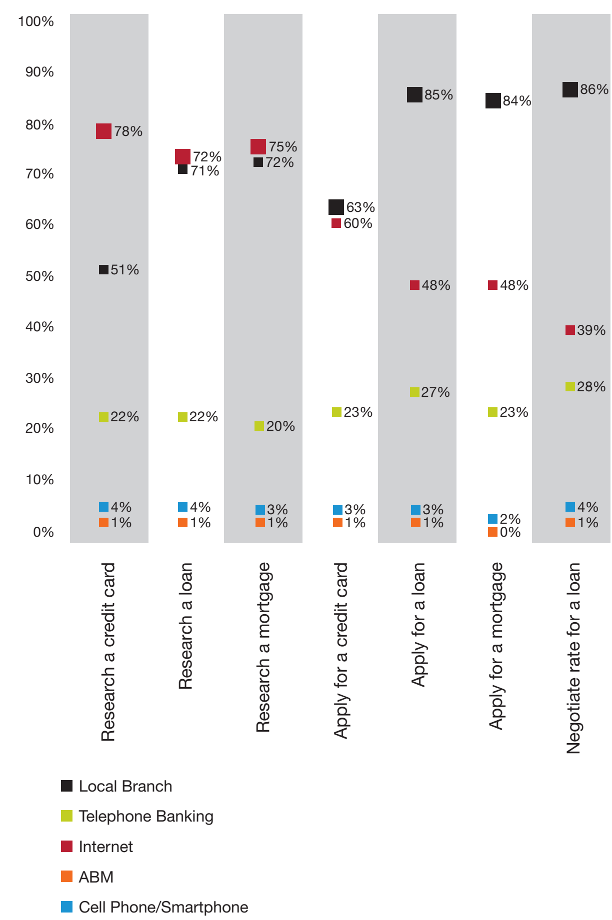
Only 1 in 10 would likely switch their primary bank in the next 12 months.

Figure 9: How likely are you to switch to another bank in the next 12 months?



With regards to loans and mortgages, the in-branch banker is by far the preferred channel for getting advice, applying, negotiating rates, and renewing or refinancing.

Figure 10: Please indicate which channel you prefer to use?



Interestingly, 47% of respondents have a personal banker. However, only 38% of those who have personal bankers meet regularly with them to discuss their personal financial situation. Seventy-seven per cent say they only meet with their personal bankers "when they want to get or change something."

The good news is that of those who do have a personal banker, an impressive 86% value the advice they receive. A similar 86% of respondents would recommend their bank to a friend or family member.

What does this mean for banks?

Given the low interest in switching and the strong customer loyalty, the current marketplace makes it difficult for financial institutions to differentiate themselves among the competition in order to acquire new customers. For banks to increase market share, they need to develop truly differentiated products and distinctly superior service levels.

Banks create opportunities for customers to leave

Many lending products have a defined term after which customers need to renegotiate

Earlier, we discussed the need to grow share of wallet for high value customers. Strangely, some lending products do the exact opposite—they create opportunities for customers to leave. For example, mortgages require that a customer renegotiate major contract terms at maturity. While various terms are available, most consumers are steered toward a 5 year mortgage, and changes to the mortgage mid-stream can trigger costly penalty payments.

Similarly, consumers often have one or more consumer loans outstanding alongside their mortgage, perhaps for a car, a second property or a consumer item. With each purchase, the customer seeks credit, to finance the acquisition. The cost of onboarding a customer, performing the requisite verifications and validations is expensive. To optimize the return on this investment, and to improve the customer experience and grow the size of the relationship with each customer, the bank should create a new product, similar to a home-equity line of credit, but with more flexibility and options, and offer **lifetime borrowing solutions** for their best customers.

Consumer Lending Transformation

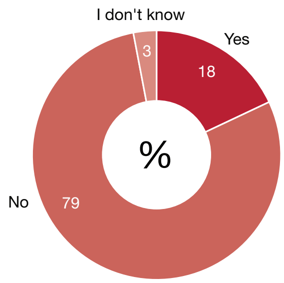
The conclusions from the first three sections are:

1. Grow the “share of wallet” for existing customers
2. Develop truly differentiated **products** and superior **service** levels
3. Offer lifetime borrowing solutions

Integrated Lending Products are designed to combine all of a customer’s borrowing into a single multi-use account secured by their home, at a lower interest rate, and with the ability to re-pay and re-borrow as their situation changes. Integrated lending products reduce risk to the bank, as they are secured through home equity, while “locking-in” the customer through an evergreen credit facility–it never expires, and can be used again and again with minimal cost to re-advance. Some of the more advanced examples allow customers to set up and manage separate facilities within the overall agreement. For example, the product can be configured to allow customers to set a portion of their mortgage to a fixed rate, for say 5 years, a second portion at a with a fixed rate for two years, with a variable rate line of credit for the balance of the loan. Similarly, the customer can set up a portion of the loan reflecting a shorter repayment time-horizon, for example, a 3 year facility to finance an automobile, a 10 year facility for a home renovation, and a 1 year facility for a vacation. The idea is to have a single aggregate secured credit product, with the ability to divide it into smaller facilities to suit the borrower’s needs.

According to the survey, 6 in 10 of the respondents have a mortgage, 7 in 10 have a line of credit, but 8 in 10 do **not** have a product like the integrated lending product.

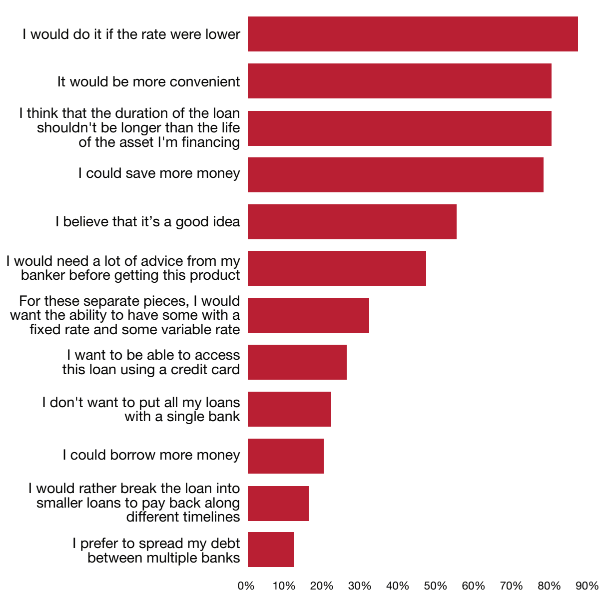
Figure 11: Do you already have a product that consolidates all your debt into a single, easy to modify loan?



How do consumers react to these products?

Overwhelmingly, 87% of respondents would consolidate their debt into a single, easy to modify loan if the rate were lower. When considering a customer's portfolio of debt, it would be simple to demonstrate the lower rate with the integrated lending product.

Figure 12: If you had the option of consolidating all your debt into a single, easy-to-modify loan, to what extent would you agree with the following?



Clearly, the opportunity, in this appealing demographic, is quite large.

How does it need to be sold?

As integrated lending products enter the market, bank staff will need to gain the right skills and attitudes to conduct needs-oriented conversations with clients.

Another statistic from Figure 12 is that approximately half (47%) of respondents would require advice from their banker before considering moving to this type of product. The good news is that since the majority of customers value their personal bankers' advice, this as an excellent opportunity for banks to build awareness and educate their clients on the potential benefits of such an integrated lending product in responsibly managing debt. This is a relatively complex product, and as such, it is necessary for personal bankers to have a conversation to understand their clients' needs, so that they can best position the most relevant product features.

To effectively promote the value of the features in integrated lending products and to match the relevant features to their customers' needs, bank staff need to spend time listening to their customers about their attitude towards debt. Additionally, this means that staff need to understand the target market for this type of product and concentrate their efforts appropriately. In our experience, the ideal customer has gone through one or more mortgage renewals, has material debt that will be carried into the future, and has sufficient financial experience to have generated insight into how the markets are moving or an opinion on where rates are going. This audience should have a borrowing time horizon long enough to justify the sales and origination effort of this more complex product and the sophistication to value the product features.

There are numerous ways to structure integrated lending products, and it turns out that consumers are looking to use the product in different ways, depending on various demographic characteristics. When looking at the product features, younger borrowers are more likely to want to split the loans into smaller tranches with specific repayment periods for each, offering them the ability to pay back loans along different timelines. More sophisticated borrowers, on the other hand, are more likely to have a view on interest rates, and want the flexibility to allocate portions of their debt between rates.

We acknowledge that most of the big banks' platforms can't easily support a product of this sophistication today. To enable these sorts of capabilities, banks need to focus on both their front-office and their core operations through the following five elements:

- **Sales and service delivery models:** We've described the required sales conversations and the basics of the target audience for the integrated lending product. Current performance measures focus on short term sales and speed of action; these need to be adjusted to help front line staff to focus on longer term product sales and more in-depth customer conversations.
- **Effective role design:** As these new sales conversations will take more time, it is important to create sufficient capacity in those roles for them to invest this required time. Identify non-customer facing activities that can be moved to a shared services function, and create specialized support functions in line with this direction.
- **Effective process design:** Today's loan origination process typically involves capturing the required data according to the screen flow in the legacy lending application. For the integrated lending product, the sales dialogue should take the form of an interview, with responses recorded online (unobtrusively) such that further questions can be triggered, and, behind the scenes, debt service ratios and loan-to-value calculated. At the end of the conversation, the customer can leave with a printout, or a web-link, to their specific scenario(s).
- **Flexible technology platform:** Most Canadian banks are looking to improve their consumer lending technology, and these projects tend to be massive and complex, and determining what to fix first can be a challenge. Elements for focus include a sales interview/scripting capability, and robust product servicing capabilities—the integrated lending product requires significant integration between servicing platforms so that balances can be shifted, and interest payments recalculated based on the new facilities without manual intervention.
- **Project implementation:** Complex transformations like the introduction of integrated lending capabilities often slip due to a lack of consensus or changing priorities. Advanced skills in project management, stakeholder management, and governance are critical to implementation. Through the execution of clear program management principles, banks can better achieve their transformation agenda.

Through the application of some or all of these project elements, banks will have a better understanding of their front- and back-end processes and in-branch activity to put in place proper project implementation plans and roadmaps. Based on our experience, going through these activities can benefit banks substantially:

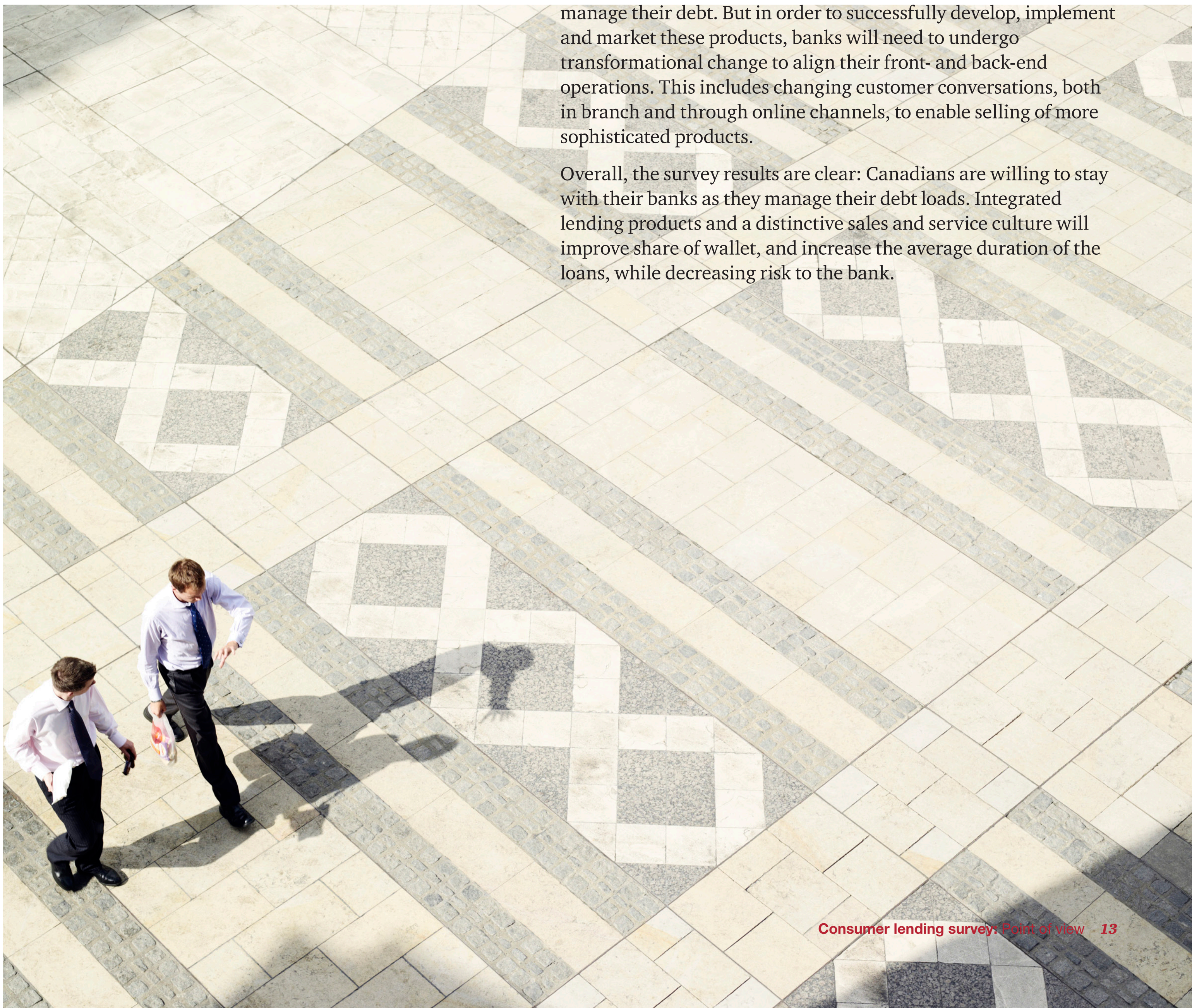
- **Improved sales and higher, longer lasting credit balances:** focusing sales time on the most likely targets and longer duration lending products.
- **Decreased costs:** more effective resource allocation to sales activities and centralization of non-customer facing processes.
- **Improved employee satisfaction:** clarity of vision improves satisfaction as staff are clear in what they need to do.
- **Improved customer satisfaction:** efficient bank/branch processes and needs driven conversations better meet clients' specific situations.

The road ahead

The results of PwC's consumer credit survey reveal that the financial crisis continues to leave its mark on Canadians. While the majority believe their banks would provide them with more credit if needed, they plan to reduce their level of debt.

So, where does this leave banks as they aim to increase their consumer lending profits? Many banks are looking to promote integrated lending products as a means to help customers better manage their debt. But in order to successfully develop, implement and market these products, banks will need to undergo transformational change to align their front- and back-end operations. This includes changing customer conversations, both in branch and through online channels, to enable selling of more sophisticated products.

Overall, the survey results are clear: Canadians are willing to stay with their banks as they manage their debt loads. Integrated lending products and a distinctive sales and service culture will improve share of wallet, and increase the average duration of the loans, while decreasing risk to the bank.



Methodology

- An online survey was conducted from September 9, 2010 to September 16, 2010.
- A total of 603 interviews were completed among Canadian adults who:
  - are homeowners with a mortgage,
  - homeowners without a mortgage, or
  - aspiring homeowners who would like to purchase in the next 6 months, and
  - have an annual household income of 100K+.
- A probability sample of the same size would yield a maximum margin of error of +\- 4.0%, 19 times out of 20.

How PwC can help

PwC's Consumer Lending team has strong analytical skills and practical experience in product management, profitability measurement, campaign design, and front line experience. We know the leading practices, and can help you to achieve them in the real world.

We can help you navigate all of the steps in a Consumer Lending Transformation:

- Role design: Modify roles to best execute against segmentation strategy.
- Process design : Tune interview and client conversations to better understand needs.
- Systems design: Integrate new technologies and capabilities.
- Motivation and rewards for client facing staff: Reward appropriate long-term behaviour.
- Large scale program management.

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