Financial Services

Precious Plastic 2010

Consumer credit in the UK

PricewaterhouseCoopers

The future of credit cards is under threat as never before. Consumers are going to be faced with the unhappy prospect of a marked reduction in the availability of credit, a reduction in choice of products and an overall increase in charges with both increased interest rates and an expansion of annual and other fees.

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The UK Cards Association

Contents

Executive summary

- 2009 has been a watershed year for consumer credit in the UK, with both lenders and consumers reassessing their balance sheets. Historically high levels of bad debt, a growing regulatory burden, continuing funding and capital constraints and the toughest macro-economic environment in a generation are placing unprecedented pressure on UK lenders.

- Total household borrowing stagnated at around £1.5 trillion. Unsecured lending remained broadly constant at around £230 billion. This is in stark contrast to the 6% growth in unsecured lending seen in 2008.

- Credit card borrowing fell by 3% to £64 billion and the number of cards in circulation fell by 8%. As a result, average borrowing per card has increased by 5% and has surpassed £1,000 for the first time.

- There has been a striking drop in new lending. Unsecured and secured lending fell by 39% and 79% respectively. This contraction is being driven both from the supply side, as lenders reduce the availability of credit, and from the demand side, with consumers less willing to take on more debt. As the recovery gains momentum and consumer demand for credit begins to return, PricewaterhouseCoopers (PwC) believes lenders will be unable or unwilling to increase supply sufficiently to match demand. This will leave consumers surprised at both the cost of credit and the difficulty in gaining access to it. Some consumers will be forced towards less mainstream corners of the industry in search of credit.

- There has been a continuing erosion of consumer confidence regarding their ability to handle personal debt. Only 32% of respondents to this year's PwC Credit Confidence survey strongly agreed with the statement "I am able to make repayments on all the outstanding credit I have". This compares with 56% last year.

- Bad debts have reached historic highs. Total credit card write-offs stood at 5.8% of outstanding balances in 2008. PwC's forecast suggests that write-offs will continue to increase and could reach 9% of outstanding balances by the end of 2010.

- PwC expects to see an increase in portfolio sales, as lenders seek to unlock liquidity and buyers return to the market. There will be opportunities for investors to acquire assets at attractive discounts.

- With traditional revenue lines under pressure the current credit card business model is no longer sustainable. PwC expects annual or monthly fees to become the norm. Fees will come from both the higher end of the market (where customers will pay for access to premium benefits) and from the lower end of the market (where more marginal customers will be expected to pay for access to even a basic credit card).

- In the medium term, lenders will innovate to establish a new sustainable business model. The industry is beginning to reposition credit cards to derive more income from usage by providing consumers with increasingly innovative ways to make payments e.g. contactless, pre-paid and mobile payments. This will reduce the industry's reliance on customer borrowing.

- PwC expects the market for retailer financial services to polarise. Some retailers will need to rigorously examine the extent to which their credit programmes are driving retail sales and work with their providers to develop sustainable customer propositions and commercial terms. For others, there exists an opportunity to expand their proposition and compete more directly with the established banks.

- The introduction of the Consumer Credit Directive by June 2010 will bring fundamental change to the way credit is sold. The additional onus the regulation is likely to introduce, regarding the provision of pre-contractual information to customers, will challenge the future of face-to-face sales. For example, this may have particular impact on retailers' ability to sell credit in-store.

- A number of banks are on the back foot and encumbered by a lack of profitability in legacy assets, there is a rare opportunity for new entrants to make significant inroads into the UK banking market. Growing political support for increased competition and the possibility of ready-made capability being for sale (as the banks seek to dispose of non-core aspects of their businesses) means time to market could be significantly reduced. As new entrants come into the market, consumers will benefit from increased choice and more competitive pricing.

- The short-term outlook for lenders and consumers looks bleak, and the road ahead will be bumpy for some time. However, the forced reassessment of lending and borrowing practices that the financial crisis has initiated should ultimately have a beneficial outcome for both parties. Once a semblance of equilibrium has been restored, lenders will emerge with more sustainable business models and borrowers should be left with more manageable levels of debt.

Market overview

Consumer credit reaches a tipping point

In 2009, total lending to consumers stagnated at around £1.5 trillion (Figure 1). While the growth rate in total consumer lending has been slowing since 2004, it is the first year that Precious Plastic has seen no growth in the overall borrowing of UK consumers.

Of the total lending of around £1.5 trillion, secured lending (mainly mortgages) stood at £1.2 trillion with unsecured lending (personal loans and credit cards etc) accounting for the balance of £230 billion.

Despite the fact that UK consumers have called a halt to increases in their debt levels, they still remain noticeably high in comparison to the rest of Europe. On average, each household has total debt of around £60,000, made up of approximately £50,000 of secured debt and £10,000 of unsecured debt. These debt levels mean that the average household will need to spend approximately 15% of net income purely to service the interest payments arising from this debt.

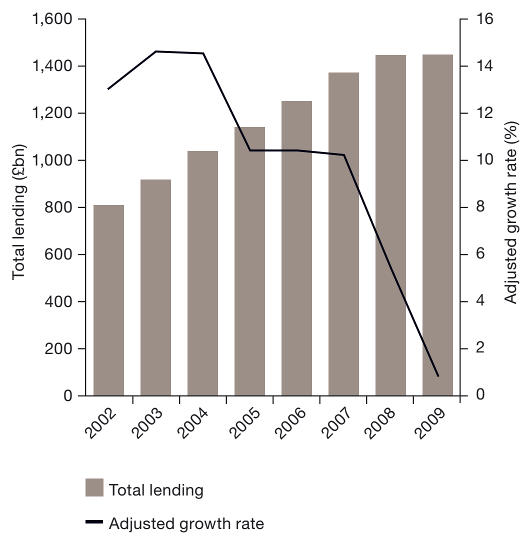
Secured lending showed a modest year-on-year increase of 0.8% over the past year. Unsecured lending remained broadly constant, in stark contrast to the 6% growth seen in 2008 (Figure 2).

This lack of growth in consumer credit balances is a result of both supply and demand factors.

On the supply side, a number of factors have combined to make lenders much more selective about who they lend to. These factors include high levels of current and expected credit losses, increasing capital requirements, pressure on funding as well as increasing regulatory requirements.

On the demand side, during the recession the consumer savings ratio has increased and consumers are clearly taking steps to redress their individual level of indebtedness.

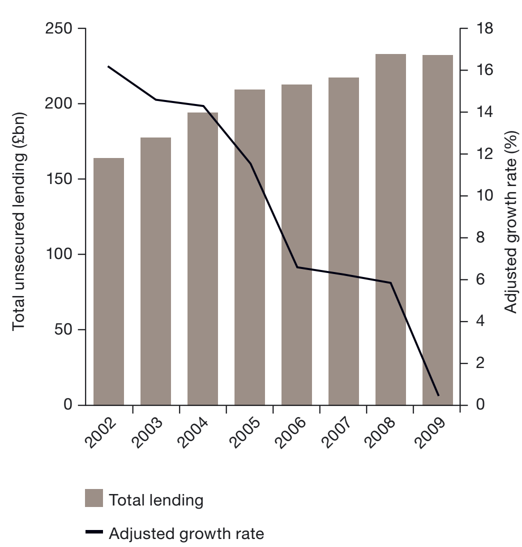
Figure 1: Total UK lending and growth rate



Note: Growth rates have been adjusted for changes in the reporting population, foreign currency revaluation adjustments and miscellaneous adjustments

Source: Bank of England, PwC analysis, all data as at 30 September

Figure 2: UK consumer credit outstanding balances and growth rate



Note: Growth rates have been adjusted for changes in the reporting population, foreign currency revaluation adjustments and miscellaneous adjustments

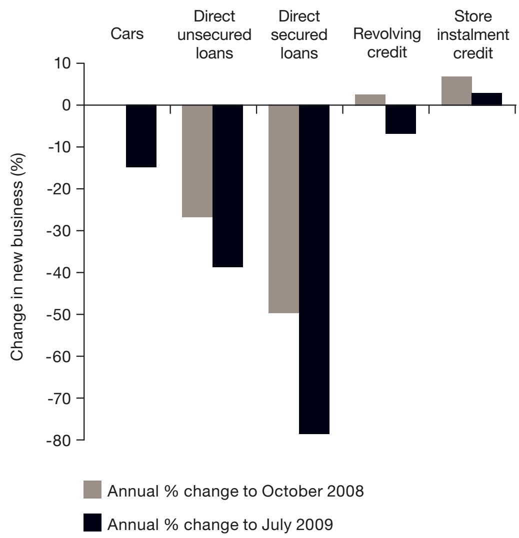
Source: Bank of England, PwC analysis, all data as at 30 September

Decline in new lending accelerates

Although total unsecured borrowing increased in 2008, there was a decline in new lending, which accelerated into 2009 (Figure 3). New secured lending (excluding primary mortgages) declined 79% and unsecured lending (excluding car loans and revolving credit) fell by 39%.

While revolving credit showed resilience through 2008, this has now been eroded in 2009 with new revolving credit falling 7%. Store instalment credit has bucked the trend in both years, showing a 3% growth on last year. One reason for this is consumers are taking advantage of competitive finance deals on the high street as retailers seek to support sales, but it is also due to the 'Waterfall effect' described in Precious Plastic 2009, where lenders have reduced the availability of personal loans and credit cards, and as a result, consumers have turned to store cards and other forms of store based credit.

Figure 3: Percentage year-on-year change in new lending



Note: Change in new borrowing for cars in 12 months to October 2008 was 0%

Source: Finance and Leasing Association, PwC analysis

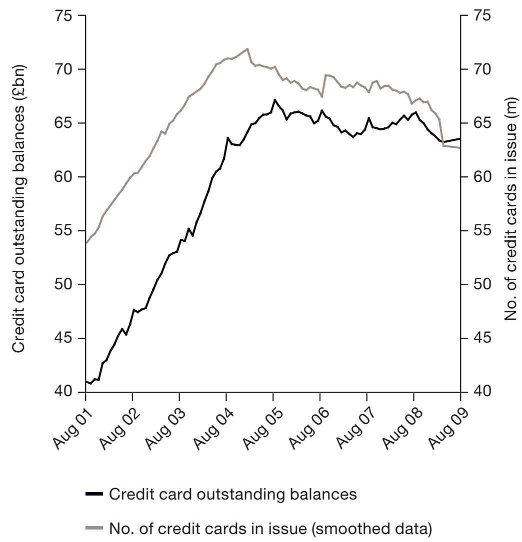
Cooling passion for plastic

According to figures from the British Bankers' Association, outstanding credit card balances have fallen by 3% over the past year, while the number of cards in issue has declined by 8%, back to levels not seen since 2003 (see Figure 4). The compound effect of these two trends means that the average borrowing per card has increased by 5%. This is a continuation of a trend that has seen average borrowing per card increase from just over £700 in 2001 to surpass £1,000 for the first time.

We believe that the contraction in credit card balances has been largely driven by actions taken by issuers. Lenders have continued to tighten their credit scoring, have been reducing credit card limits and have been taking actions to rationalise their customer bases. The recent announcement by one major issuer that they would not generally seek to acquire new credit card customers without those same customers also holding a current account with them is in stark contrast to the time when credit card issuers accounted for one in every four pieces of mail that made it through our letterboxes.

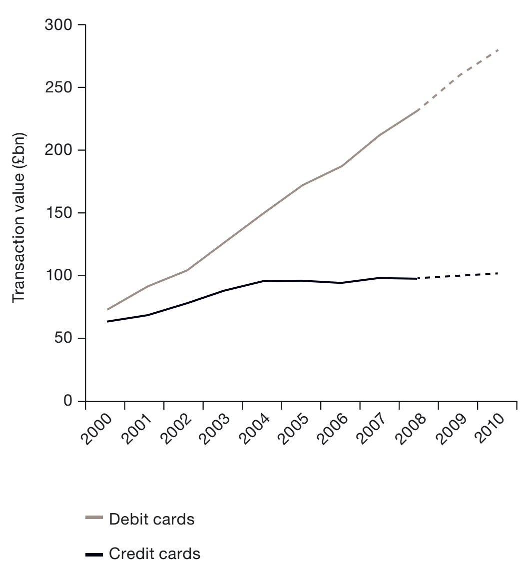
These trends in the credit card market are fuelling the continued divergence between the use of credit cards and debit cards on the high street. In 2008, the number of debit cards in circulation increased by 6% over the previous year. Debit card transactions value increased by 9% from the previous year to £241 billion, representing 63% of total card transactions by value (Figure 5). By comparison, credit card transactions stagnated, with the value of annual spend falling to 27% of total card spend. Forecasts from the UK Cards Association suggest these trends are set to continue.

Figure 4: Credit card outstanding balances and cards in issue



Source: British Bankers' Association, PwC analysis

Figure 5: Annual card spend: Credit vs. Debit



Source: The UK Cards Association, PwC analysis

PwC Credit Confidence survey

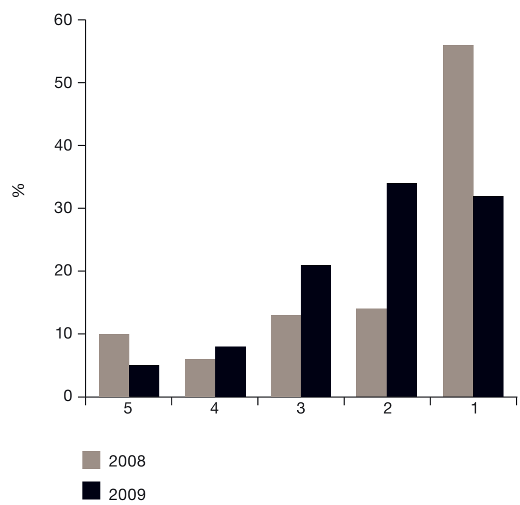
The PwC Credit Confidence survey, conducted by YouGov, among over 2,000 UK consumers, assesses attitudes to consumer credit conditions.*

Debt repayment remains a concern

The survey shows that servicing unsecured credit remains a major concern for many UK consumers. Of those questioned, 13% reported they were unable to make repayments on their existing credit commitments with 25% concerned about their ability to make repayments in the future (Figures 6 & 7).

Although this represents a slight improvement on 2008, when 16% of respondents reported current debt repayment problems and 27% revealed future funding concerns, general uncertainty surrounding personal indebtedness is now much greater.
Only 32% of UK consumers were highly confident that they will be able to make repayments on all their outstanding credit, compared with 56% in 2008.

Figure 6: I am able to make repayments on all outstanding credit I have



Note: 1=strongly agree, 5=strongly disagree

Source: YouGov, PwC Credit Confidence survey

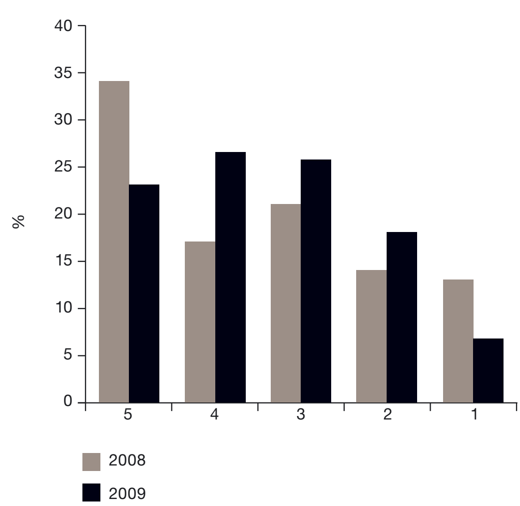
Prudence prevails

The PwC survey found widespread concern about the prospect of pay freezes and redundancies. 28% expected their pay to be frozen or reduced over the next 12 months while only 16% were highly confident that their income would not suffer. Further, although 52% of respondents felt that they had job security, almost one in five were worried about being made redundant over the next 12 months. However, 8% of respondents recognised that they have actually benefitted financially from the credit crisis. PwC believes this is primarily driven by lower mortgage repayments.

Survey key

5	Strongly disagree
4	Disagree
3	Neither agree nor disagree
2	Agree
1	Strongly agree

Figure 7: I am worried about my ability to make repayments on debt in the future



Note: 1=strongly agree, 5=strongly disagree

Source: YouGov, PwC Credit Confidence survey

* YouGov carried out the survey on 14-16 September 2009. It was conducted online, targeting a selection of individuals from their database that is representative of the UK population. The responding sample was subsequently weighted in order to provide a representative reporting sample and this weighting was based upon census data.

Impact of the recession on disposable income

	PwC view	Main drivers
Young people (16-24)	Moderately negative	+ Low debt levels – High risk of unemployment
Families (25-45)	Moderately positive	+ Earnings growing for those that keep their jobs + Benefit from decreased interest on mortgages
Empty nesters (45-65)	Moderately positive	+ Lowest risk of unemployment; earnings growing for those that keep their jobs – Less benefit from reduced interest rates as less likely to have a mortgage
Pensioners (65+)	Strongly negative	– Pension fund values have declined, leaving pensioners less well off and uncertain about the future – Interest rates on savings reduced
Low income	Moderately positive	+ Guaranteed increase in minimum wage and benefits + High % spend on non-discretionary items – benefit from deflation in e.g. food – More likely to be struggling to repay debts
High income	Moderately negative	+ More likely to be in debt so benefit from lower interest rates – Impact from lower bonuses

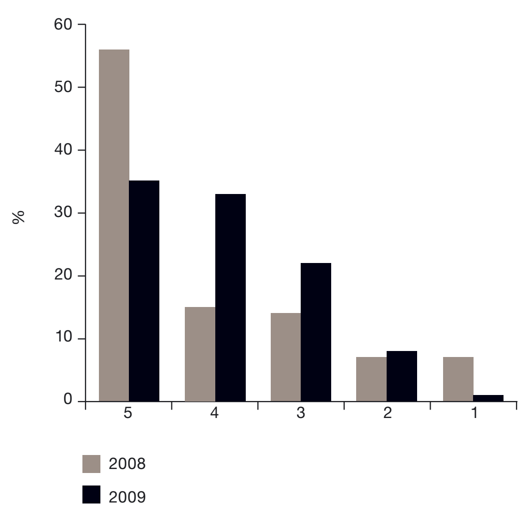
Strongly positive · Moderately positive · Moderately negative · Strongly negative

Source: PwC analysis

As the table above indicates, it is young people and pensioners who are likely to be hardest hit by the recession. The level of indebtedness for 18 to 24 years olds is growing, and university leavers are faced with both a stagnant job market and an increasing difficulty in accessing credit. PwC found that 12% of 18 to 24 year olds had been turned down for credit in the last three months and 17% planned to use more credit in the next three months compared to previously. These results are the highest of any age category surveyed. The survey also revealed that 18 to 24 years olds are the most worried about the availability of credit for future purchases.

Fears about the future have introduced a marked trend towards financial repair among UK consumers. PwC's survey found that 35% of consumers intend to save more money over the next 12 months. Only 9% of consumers surveyed planned to use more credit in the next three months compared with 14% in 2008 (Figure 8). Yet despite the new climate of credit caution, 25% of consumers were concerned about the availability of credit for future purchases.

Figure 8: I plan to use more credit in the next 3 months compared to previously



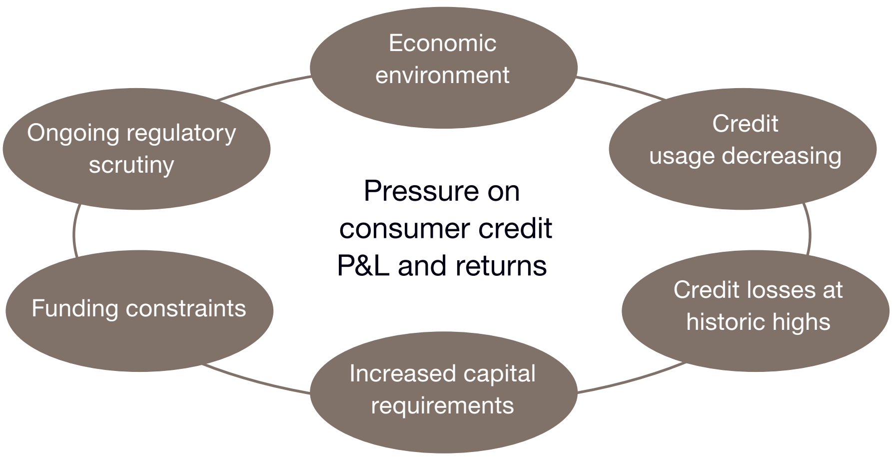
Note: 1=strongly agree, 5=strongly disagree

Source: YouGov, PwC Credit Confidence survey

Unprecedented pressure on lenders

Historically high levels of bad debt, a growing regulatory burden, funding and capital constraints and a tough macro economic environment are combining to place unprecedented pressure on UK lenders. In this section we explore each of these factors in more detail.

Figure 9: Unprecedented pressure on the consumer finance P&L



Credit losses at historic highs

In order to forecast potential future losses, PwC has prepared a model examining the historical relationship between losses and key macro-economic indicators and has analysed the position with regards to credit card lending. Annual credit card write-offs reached £3.2 billion, representing 5.8% of outstanding balances in 2008 (Figure 10). PwC forecasts that write-offs will continue to increase and, unless lenders take action, could reach 9% of outstanding balances by the end of 2010. The potential increase in write-offs is dramatic and levels of write-off of this magnitude have never been experienced by the UK industry before.

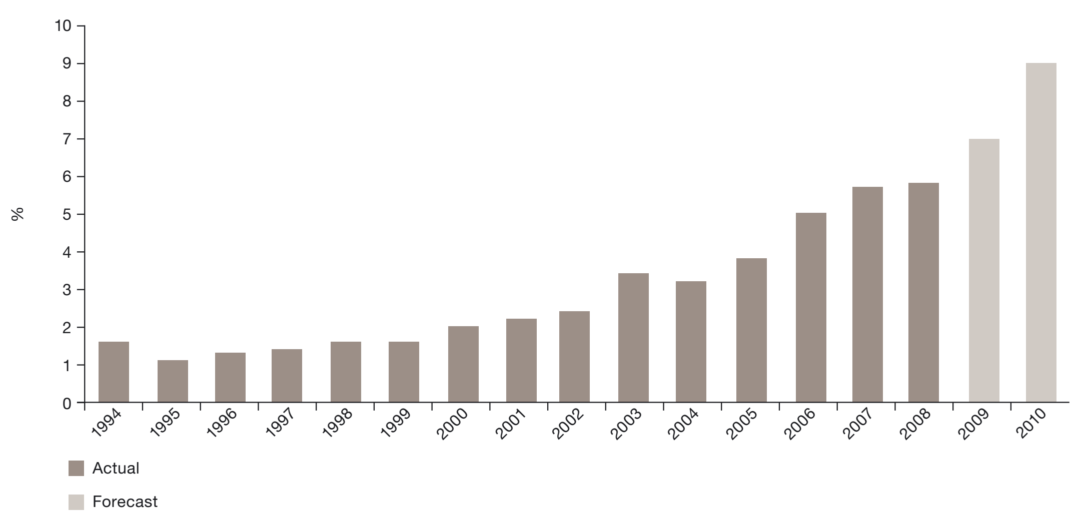
In PwC's view, there are multiple factors which are likely to have an impact on rising bad debt. From a macroeconomic perspective, unemployment is expected to reach even higher levels. In addition, there has been an increased shift in those still employed moving from working over 35 hours per week to less than 35. PwC's Credit Confidence survey found that 28% of respondents expected their pay to be frozen or decreased over the next 12 months. Finally, the housing market, while having shown some signs of recent recovery, remains depressed, resulting in lower home equity and consequent refinancing difficulties. The PwC forecast implicitly assumes no change to base rates. Any increase in consumer lending rates could adversely affect levels of bad debt.

The macro-economic consulting team at PwC provides advice on a broad range of economic issues in the financial services sector. Our experienced economists use a range of econometric and other quantitative tools to model key business drivers and generate both macroeconomic forecasts and bespoke projections.
We have helped banks, hedge funds and governments understand better what is happening in their sectors by providing robust analysis and forecasts of key metrics such as credit risk, probability of default, loss given default, and write-offs.

In addition, while the Nationwide Consumer Confidence Index has shown a rally since the lows of January 2009, recent data from the Citizens Advice Bureau shows a 27% increase in new debt queries in the second quarter of 2009 compared with the same period in the previous year.

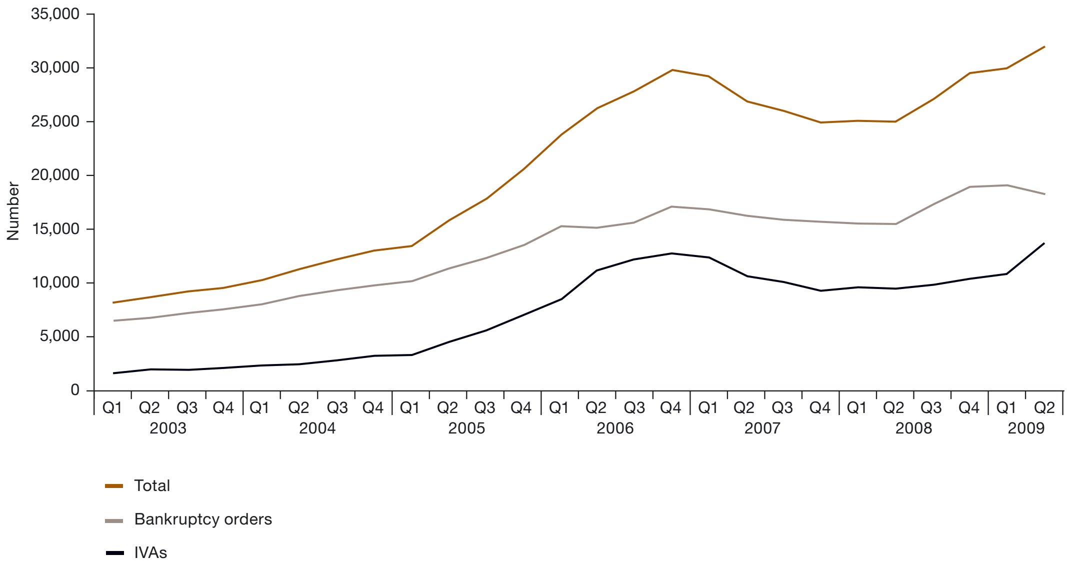
Further, as noted earlier in this report, PwC's Credit Confidence survey found that 13% of respondents felt unable to meet all their existing credit commitments, with 25% concerned about their ability to do so in the future.

Figure 10: Credit card write-offs as a proportion of outstanding balances



Source: Bank of England, PwC analysis

Figure 11: Quarterly number of personal insolvencies

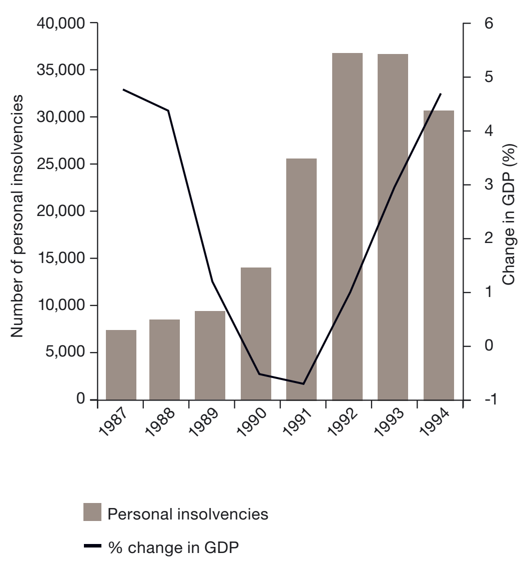


Source: Insolvency Service, PwC analysis

Data from the Insolvency Service shows that personal insolvencies (Individual Voluntary Arrangements (IVAs) and personal bankruptcy orders) are currently at the highest levels on record (Figure 11). Personal insolvencies now have a run rate of more than 120,000 per annum. In addition to these reported insolvencies, PwC estimates there will be between 100,000 and 150,000 Debt Management Plans this year. Taking these combined debt solutions into account suggests that, on average, around 1,000 people are seeking some form of formal debt rescheduling every working day.

Experience from the previous recession suggests that the level of personal insolvencies generally lags the GDP-based economic cycle, with the height of personal insolvencies post the 1990-91 recession occurring one to two years after the bottom of the recession (Figure 12). If a similar cycle were to be experienced after the current recession, personal insolvencies would likely continue to rise during 2010 and 2011, even if it is assumed that the worst of the economic recession is over.

Figure 12: Personal insolvencies lag GDP in a recession



Source: Insolvency Service, Office of National Statistics, PwC analysis

In the short to medium-term, bad debt levels will almost certainly continue to rise as consumers' inability to repay debt increases. Although the first signs of economic recovery are beginning to emerge, bad debt trails macroeconomic factors such as GDP and unemployment. Therefore, PwC expects high levels of debt defaults and write-offs to characterise the UK consumer finance market for at least the next couple of years.

PwC can assist creditors in finding straightforward and practical solutions for insolvency cases of any size. By providing leading-edge expertise and running specialist bankruptcy processing centres, PwC is able to help creditors manage costs, increase recoveries and encourage the payment of dividends to creditors as early as possible.

For individuals, PwC's services include general personal insolvency advice around the various insolvency options that are available, as well as acting as Trustees in Bankruptcy, supervisors of IVAs and PVAs, negotiating IVAs, and dealing with charging orders.

Increasing capital requirements

With rising bad debt levels, additional supervisory capital requirements and potential changes to capital adequacy regimes (such as tougher liquidity requirements), more capital will be required by the UK banking sector.

Further, increasing capital requirements will result in an increased cost to the lender for each pound lent to consumers. Rather than focusing principally on growing volume, lenders will be more focused on profitability and will aim to use their capital more efficiently with an increased emphasis on 'risk-adjusted return on equity'.

Forging an explicit link between sources of capital, credit scoring and lending will require greater cross-functional communication and coordination. Capital managers at group level have had to put new frameworks into place and fundamentally change the way they operate to ensure that 'capital in' and 'credit out' functions work closely together. This area will require continued focus and improvement.

For consumers, this is likely to mean that the cost of borrowing will increase while credit availability will decline – a theme we explore in more detail later in this report.

Funding constraints

Data from the Bank of England shows the gap between lending and deposits stood at almost £850 billion at the end of 2008, having widened dramatically in recent years (Figure 13).

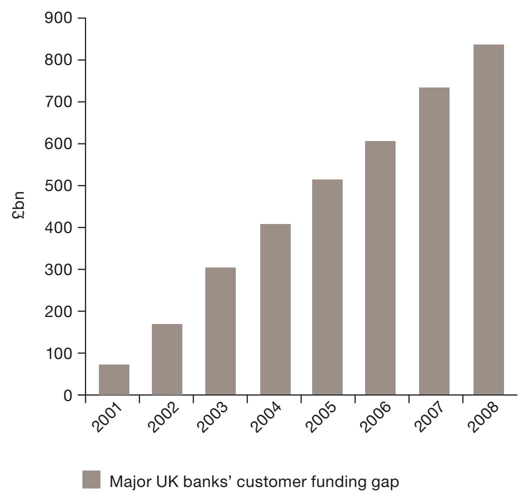
During the years leading up to the banking crisis, banks were increasingly operating a 'leverage model', whereby they lent more than they held in deposits. This was achieved through reliance on wholesale funding (including securitisations), which prior to mid-2008 was readily available and relatively inexpensive.

In the aftermath of the banking crisis, the UK observed a near-drought in the wholesale funding market with the Government forced to intervene to provide funding in order to prevent banking collapses. As the Government slowly begins to withdraw from the bank funding market, lenders are likely to have to cut back lending or find alternative sources of funding, where affordable, in order to bridge the gap. Many banks are seeking to increase their deposit base, or seeking authorisation to take on deposits where they did not already have this capability.

While there is an argument that the decline in capacity of banks to lend is currently mirrored by a lower demand for credit, data from the International Monetary Fund (IMF) indicates that the demand for credit from consumers is likely to return faster than lending capacity, leaving consumers surprised at both the difficulty of obtaining credit and its cost (Figure 14).

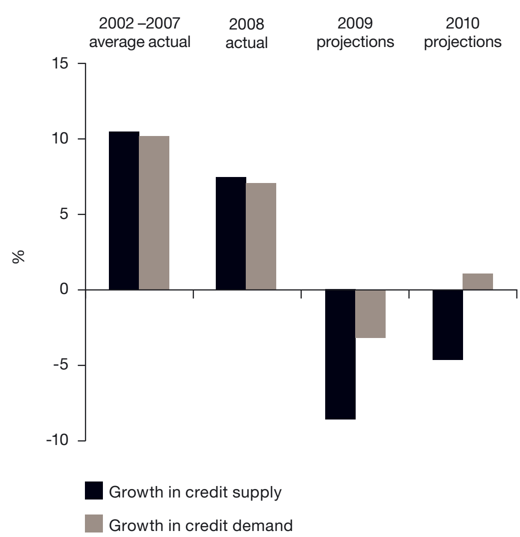
PwC expects an increased focus from lenders on risk and liquidity management. Lenders will be faced with potential restructuring options. If looking at selling portfolios, they will have to assess the capital benefit from selling against any discount they take to book value.

Figure 13: The funding gap between lending and deposits



Source: Bank of England, Dealogic, PwC analysis

Figure 14: Bank lending capacity and credit demand growth



Source: IMF, PwC analysis

Regulatory scrutiny: death by a thousand cuts?

Scrutiny and regulation of the consumer credit industry has continued to increase through 2009 and shows no signs of slowing. Pressure has come from many sources: from the Office of Fair Trade (OFT) with respect to its investigation into unauthorised overdraft charges and their consultation on irresponsible lending; from claims management companies acting on behalf of consumers to exploit areas of uncertainty in existing legislation (e.g. the requirement for lenders to provide an original signed credit agreement on demand); and from the Competition Commission with its ruling restricting the sale of payment protection insurance (PPI). In addition, the industry is faced with the need to implement three major regulatory changes in only four years: the Consumer Credit Act 2006, the Payment Services Regulations 2009 and, for 2010, the Consumer Credit Directive (CCD). The growing challenges are creating barriers to entry and placing such pressure on margins that the cumulative effect could be to reduce choice and increase costs for consumers.

The Consumer Credit Directive

The CCD is due for implementation in the UK by 10 June 2010. The draft regulations implementing the CCD into legislation have been published and consultation is now closed. However, the path to implementation is less than clear, with the Department for Business, Innovation and Skills (BIS) stating that, despite consultation being closed, 14 points of principle and 30 substantial conceptual issues remain unresolved. The CCD introduces a plethora of changes to pre-contractual information, agreement content, consumers' rights of withdrawal and early settlement.

The stated purpose of the CCD, which will harmonise regulation across the EU, is to enhance consumer choice and reduce cost by increasing competition. However, the prospect of universal documentation and a one size fits all approach to the EU credit market seems remote. The additional onus the regulation is likely to introduce, regarding the provision of pre-contractual information to consumers, will challenge the future of face-to-face sales. This may have particular impact on retailers' ability to sell credit in their stores.

The Consumer Credit Directive

In its July 2009 White Paper 'A Better Deal for Consumers', the Government highlighted the core components of the CCD implementation to be:

- A duty on the lender to provide adequate explanations about the credit on offer
- An obligation on the lender to check creditworthiness before offering or increasing credit
- A requirement to automatically disclose the identity of credit reference agencies holding information which has led to a consumer's application for credit being rejected
- A right for consumers to withdraw from a credit agreement within 14 days, without justification
- Requirements for credit intermediaries to disclose fees they charge for arranging credit and to make clear whether they are tied to specific credit providers
- A new right to make partial early repayment of credit (in addition to the existing right to repay early in full)
- A new standardised pre-contractual information sheet enabling consumers to compare offers more easily
- A requirement to comply with the findings of the OFT's consultation on irresponsible lending, which has four principles:
    1. appropriate business practices and procedures (e.g. lenders must assess the suitability of a product and the consumer's ability to repay)
    2. transparency in dealings (e.g. clear language, prominence of key terms)
    3. proportionality (e.g. with respect to how lenders deal with arrears, defaults and forbearance)
    4. fairness (e.g. with respect to not targeting consumers with inappropriate products or aggressive, deceptive, unfair or prejudicial behaviour)

No let up in sight

As well as setting the framework for implementing the CCD, the White Paper ('A Better Deal for Consumers') also details how the Government intends to make the credit market work better for consumers. Proposed actions include the introduction of a consumer advocate, a review of credit card and store card regulation and a review by the OFT of high cost credit markets.

In the background, the interchange fees debate continues with the consequent potential of reduced income for the credit card industry.

At the European level, 2010 will see the introduction of the EU Consumer Rights Directive, which is expected to provide further enhancement to consumer protection in a number of markets including financial services. The European Commissioner for Consumer Protection has referred to the need to advance consumer protection in the financial services industry to the same levels seen in product areas such as food safety.

Of the various regulatory interventions ahead, we focus below on the BIS consultation on credit and store cards and the Supreme Court ruling on unauthorised overdraft charges.

BIS consultation on credit and store cards: The final straw?

On 27 October 2009, BIS launched its consultation on credit and store cards. Many of the areas identified for consultation also featured in the recent US Credit CARD Act. BIS has identified five primary areas for consultation:

- Payment allocations: examines whether the allocation of customer payments should be changed to ensure that more expensive debts are repaid ahead of cheaper ones.
- Minimum payments: examines whether a higher mandatory minimum repayment should be introduced to help consumers clear their balances more quickly.
- Re-pricing existing debt: examines a range of options, including banning interest rate changes on existing debts or placing restrictions on the circumstances in which lenders can carry out re-pricing.
- Credit limit increases: examines the impact of introducing a ban on unsolicited increases altogether or requiring consumers to opt in to credit limit increases.
- Simplicity and transparency: examines how to improve simplicity and transparency in the industry to help consumers make better choices and encourage switching.

The stated objective of the consultation is to "secure a better deal for consumers, giving them improved control of their credit and store card borrowing, whilst also ensuring that any intervention is proportionate, transparent and targeted". Based on discussions with issuers in the US who are already grappling with the measures contained in the US Credit CARD Act, PwC believes that with the UK credit card business model already under significant pressure, any further measures to restrict issuers could increase the cost of credit cards to consumers and reduce their availability to certain segments of the market. Issuers will focus on those consumer segments that are the most profitable, rather than those that are in the most need of credit.

Ruling on unauthorised overdraft charges: The end of free banking?

In both the UK and the US, credit card issuers already face restrictions on their ability to set penalty fees. In the UK, the OFT has been investigating unauthorised overdraft charges since 2007. In the US, Congress is also considering proposals to introduce restrictions.

The industry has challenged the OFT's ability to regulate unauthorised overdraft fees, however, after losing before both the High Court and Appeal Court, the decision now rests with the Supreme Court. At the time of going to press, PwC expects an imminent ruling from the Supreme Court against the banks, confirming that unauthorised overdraft charges should be subject to a fairness test by the OFT. The OFT has estimated that £2.6 billion in revenue is at stake for the banks.

Unlike some European markets, UK consumers have largely received basic banking services for free. A Supreme Court ruling in favour of the OFT could trigger a fundamental change in the way consumers pay for banking services. Consumers could increasingly be expected to pay a fee for their current accounts; this will place pressure on the banks to create value propositions for which customers are prepared to pay. The banks may also restrict the extent to which customers are able to access unauthorised overdraft facilities, forcing these consumers to rely on other credit sources when faced with unexpected borrowing requirements.

The US Credit CARD Act

On 22 May 2009, US President Barack Obama signed into law the Credit Card Accountability Responsibility and Disclosure Act. This Act includes substantial changes to the regulation of credit cards. According to Federal Reserve Chairman Ben Bernanke "the revised rules represent the most comprehensive and sweeping reforms ever adopted by the Board for credit card accounts. These protections will allow consumers to access credit on terms that are fair and more easily understood."

The primary topics considered are as follows:

Payment allocation: Payments made in excess of the minimum payment must be applied first to balances with the highest interest rates or pro rata among all balances.

Rate increases: Requires the disclosure at account opening of all interest rates that will apply to the account and prohibits increases in those rates.

Fees and charges: Limits certain credit card fees and charges, such as over-the-limit and late payments fees.

Two-cycle billing and on-time payments: Bans the use of double-cycle billing and prohibits charging interest on any portion of a balance subject to a grace period if it was repaid in a timely manner.

Customer ability to repay: Prohibits issuance of cards or increase of credit limit unless the issuer considers the actual ability of the customer to repay.

Stored value cards: Requires that all gift cards have an expiration date of at least five years and prohibits dormancy fees.

Credit for young adults: Prohibits issuance of credit to individuals under 21 years old without a co-signer aged 21 years or older or proof of an independent means of income to repay the credit.

What next?

Historically high levels of bad debt, funding and capital constraints, increasing regulatory scrutiny and a poor macro economic environment have combined to place unprecedented pressure on UK lenders. These pressures have affected various business models in different ways; some have weathered the storm, some are moribund, while others are left needing to fundamentally change. The following section explores the impact on banks, retailers, new entrants, consumers and the need for innovation in the industry.

Banks focus on the core

Despite the significant challenges ahead, a recent confidence survey (September 2009) conducted by the CBI and PwC, showed that the banking sector is experiencing an upswing in confidence, with the most positive response from the banks since June 2007, before the start of the financial crisis.

Although most banks are beginning to move from survival mode to planning for the future, more time and resources need to be dedicated to defining the business strategy and the operating model required to execute it. Fundamental changes in strategy and skill-set will be required to succeed in the “new normal”. The severity of the crisis, together with some changes in leadership teams, creates the rare conditions under which true transformational change can be conceived and executed.

Lenders are focusing on a number of areas; enhancing in-house collection strategy and operational effectiveness, cutting costs and outsourcing where possible, trying to increase income through, for example, re-pricing segments of their portfolios, and rationalising products.

With funding and capital constraints, banks will continue to de-risk and deleverage their balance sheets. Banks will become increasingly selective in terms of who they lend to, leaving certain consumer segments struggling to gain access to credit from mainstream lenders. As banks focus on their core business, in addition to disposing of non-core loan portfolios, some will go further and undertake strategic reviews of entire business units; this could create some exciting opportunities for new entrants.

PwC can assist financial services companies navigate the rapidly changing landscape. PwC uses deep industry expertise and a combination of creative strategic insight and rigorous analytics to help management teams make the right decisions for their businesses.

Deleveraging and de-risking the balance sheet is just one aspect of the strategic review the banks must undertake. The following table sets out other areas banks will need to focus on:

Balance sheet repair	• Continued focus on de-risking and deleveraging the balance sheet • Increase in restructuring and sale of non-performing portfolios • Banks will become increasingly selective in terms of who they lend to
Strategic cost reduction	• Few banks have a thorough understanding of their cost base and allocations • Most banks will need to significantly reduce their cost base • A strategic approach will be required to ensure cuts do not put revenues at risk
Increased focus on risk management	• Banks will upgrade people and infrastructure in risk management • Redesigned organisational structures must place risk management at the centre • Banks will be increasingly selective over who they lend to
Collections and recoveries	• Relatively low losses over the last decade left collections departments lacking investment • As banks seek to optimise retained assets investment will increase • Some banks may seek to work with specialist third parties
The fight for deposits	• The financial crisis exposed the risks of an over reliance on wholesale funding • A greater emphasis on attracting and retaining a sustainable deposit base is required • Intense competition will make it difficult and expensive to attract and retain deposits
Pricing reviews	• There will be a widening gap between supply and increasing demand for credit • In addition, margins are under pressure. Banks will undertake pricing reviews • Stronger banks may charge a premium for the perceived security they offer consumers
People and remuneration	• Shift in focus from top line growth to risk / capital management, collections and cost • Staff objectives and remuneration will need to be realigned, taking account of regulatory requirements • New skill sets will be required and talent will need to be strengthened in certain areas
Divestments and acquisitions	• Increasingly focused on their core business, banks will divest non core assets • Suppressed valuations in the industry will create an opportunity for acquirors • Investors (hedge funds and private equity) will become more active
Dealing with regulation	• Banks will need to deal with a wide array of increasingly prescriptive regulations • The timing and extent to which Government scales back support remains unclear • Increasingly prescriptive capital requirements are likely to reduce returns

Portfolio sales

2007 and early 2008 saw record levels of activity in the market for the sale and purchase of unsecured debt portfolios in the UK. Some of the activity was due to emergency sales, as distressed sellers sought a rapid exit from certain segments of the market. However, since the second half of 2008, activity has been at a virtual standstill.

Complex accounting considerations, a lack of well-funded and experienced buyers and mismatched price expectations have combined to constrain debt-sale activity during 2009.

The accounting treatment of arrears and non-performing debt within a loan portfolio can have a major impact on a lender's commercial decision as to whether to sell. Under IFRS, many secured and unsecured financial receivables are held at amortised cost less impairment. Under this accounting principle there must be a 'trigger event' – such as a customer going into arrears – for an impairment provision to be booked. However, when determining their bid value, prospective buyers are factoring into the offer price their own expectations of 'lifetime losses' – regardless of whether a 'trigger event' has occurred. Therefore, at the time of a debt sale, a seller is often faced with crystallising a large accounting loss in their income statement.

Activity set to increase

During 2010, PwC expects to see an increase in debt sales, as a result of a number of factors:

Strategic decisions by lenders: PwC expects many lenders to make operational decisions about whether they want exposure to particular sectors or geographies.

Buyers returning to the market: PwC expects cash-rich private equity funds, hedge funds and sovereign wealth funds to start returning to the market.

Ability to offset losses: For large financial institutions, an upturn in the profitability in other parts of their businesses could enable them to absorb the accounting losses they would need to realise in order to sell certain portfolios.

Aligning price expectations: The price expectations of buyers and sellers are likely to become better aligned with sellers more willing to accept lower prices as they adjust to the reality of the current environment and buyers able to pay slightly more than previously as they become increasingly confident in their estimate of future credit losses.

PwC regularly acts for buyers and sellers of loan portfolios providing advice on strategies and structures for a transaction and applying proven and robust valuation methodologies. PwC can facilitate deals and maximise sales prices achieved through its access to an international network of investors and support transactions with an integrated team of financial, due diligence, valuation, tax and accounting specialists.

Optimising collections

Getting the best out of existing portfolios

With bad debts increasing, lenders will need to shift focus from the traditional collections call centre model to a special servicing model. Special servicing is relatively costly and not a core competency of most lenders as they have not had to invest in this area in the last decade. To achieve better collections, lenders are therefore faced with building special servicing capabilities or outsourcing to a specialist debt servicer. Retention of collections in-house allows lenders to maintain control over collection strategies, the customer relationship and any resulting impact on the brand. However, it will be a slow process to train or acquire staff with the required expertise.

Outsourcing, on the other hand, enables lenders to focus on core activities and use experts who have economies of scale and the ability to implement special servicing practices immediately. If this is to be successful though, there needs to be a focus on aligning the objectives of the lender and the service provider at the outset of the relationship.

In either case some degree of investment is going to be required in an environment where there is pressure to cut costs and limit new expenditure.

Whichever route is taken, there are some key strategies required to maximise returns, some of which we mention below:

Early intervention strategies – in today's market, the ability to identify "at risk" customers who have yet to default, but show characteristics of those that are likely to do so, is key to tackling the problem head-on and finding a solution which works for the customer as well as the lender.

Combined view of customer relationships – synergies could be achieved in early stage arrears cases through looking at all the relationships a lender has with the customer across multiple products. This will influence the collection strategy because the lender will have more behavioural data on the customer.

Merged functions – typically early stage, late stage and loss mitigation functions within collections have been separate with a hand-over relationship as the customer flows through the process. However, PwC considers the leading edge collections functions to have integrated functions allowing feedback loops of information gathered at each stage on the behaviour of customers. This data can then be used to influence the contact strategies, for example at early stage arrears, or before the customer has reached this phase.

Creative collections strategy – the ability to analyse and understand customer data is invaluable when it comes to determining which customers best fit a particular collections strategy. For example, PwC has witnessed players offering incentives to customers to pay off balances by offering discounts to the principal, but if these customers were more than likely to repay in full then this strategy can be value destroying. Technology can also play a role in improving customer contact and therefore collections; some players have gone as far as sending customers prepaid mobile phones for them to call on.

Polarisation of the retailer credit market

At the outset, the primary motivation for retailers to offer their customers credit was to increase retail sales. However, over the last 10 years as retailers began partnering with financial institutions, this initially straightforward motivation shifted. Leveraging their brand and ready-made distribution channels, many retailers capitalised on burgeoning demand for credit and relatively cheap and easy access to funding, to expand their financial services offering with the objective of it becoming a profit centre in its own right. The extent to which credit programmes were driving retail sales became less important.

This model is now under pressure. Rising bad debts, regulatory interventions and balance sheet constraints on lenders have compressed margins thereby making lending significantly less profitable. In addition, consumers have demonstrated that whilst they trust many retail brands, the stretch into other financial services products (e.g. insurances, credit cards, savings) for some has been a leap too far – and the actual returns from financial services have failed to live up to expectations. While the financial model for retailer credit is under pressure, not all participants will be impacted equally, and PwC expects the market for retailer credit to polarise.

At one end of the spectrum, many retailers will no longer be able to view financial services as a sustainable standalone profit centre. These retailers will need to rigorously reassess the extent to which their programmes are driving retail sales. If increased sales do result, then retailers will need to work with their finance providers to find sustainable product propositions and commercial terms that work for both the retailers and the financial institution. If the link to retail sales is more tenuous, retailers will need to carefully consider their customer proposition and the future of some programmes may be in doubt.

At the other end of the spectrum, some retailers (or big brands) with sufficient brand equity, distribution and financial strength have a golden opportunity in the current market to capitalise on the weakness of some of the established banks and expand their financial services offering to compete with banks more directly. The current growth agenda of Tesco Bank is a prime example. For most retailers, PwC believes partnering with a financial institution remains the most sustainable route to expansion rather than the retailer establishing or acquiring its own capabilities.

The Consumer Credit Directive: a catalyst for change?

We have previously discussed the Consumer Credit Directive, which is due to be implemented by June 2010. This brings with it a significant increase in the pre-contractual information lenders are required to provide to borrowers. Those selling credit will require a greater level of training to ensure they are able to provide consumers with 'adequate' explanations regarding credit offers and be able to address questions. While the industry is still assessing its response, PwC believes some lenders may pull back from face-to-face sales entirely; preferring to leverage the internet where the sales process can be better controlled. For less profitable retailer credit programmes, the effort involved in ensuring compliance of the retail staff selling credit may be too onerous.

Adapting the business model

As the market begins to polarise, PwC believes there will be significant changes in the retailer credit industry. In 2010, PwC expects to see:

- Reduced emphasis on customer acquisition: The historical model of offering a discount to encourage new customers to open an account has driven the wrong customer behaviour, leading to a high number of transitory short-term customers. Given the pressures on profitability, coupled with the introduction of the CCD, this model is unlikely to be sustainable. As lenders seek to focus on quality over quantity, this will create a tension with their retail partners for whom inclusion will remain the imperative.

- Introduction of new fees: New sources of revenue will be required to improve the profitability of retailer credit programmes and the pressure on store cards to introduce new fees will be particularly acute. Some retailers are well positioned to construct attractive benefits packages that can command a fee, for example the 'Premium Club' launched by Marks & Spencer. PwC expects to see others follow suit.

- Closure of non-profitable programmes: As the compliance burden increases, those programmes that are no longer profitable and can demonstrate only a tenuous link to retail sales are likely to be significantly scaled back or closed entirely. This will raise important questions for retailers in terms of how to avoid disenfranchising their customers.

- Continued growth in instalment credit: While retail sales remain subdued, particularly in the case of big-ticket items, and the availability of alternative sources of credit remains constricted, PwC believes it is more important than ever for retailers to offer their customers financing options. It is interesting to note that retail instalment credit was the only category of consumer credit new lending to grow in the last 12 months, indicating resilient consumer demand. Growth and competition in the instalment credit market may provide conditions for innovation, in a product area that has historically remained relatively simple.

- Increased emphasis on non-lending products: As consumers become more cautious in terms of taking on credit, PwC expects to see an increase in the use of pre-paid cards, promoting a number of benefits including "financial responsibility". For those with the strongest brands, there is a significant opportunity to capitalise on the lack of trust in the banks and expand into savings and investment products, if relevant banking licences can be obtained.

A rare opportunity for new entrants?

A number of banks are on the back foot; their brands have been damaged and they have lost the trust and confidence of their customers. Some banks are preoccupied with repairing their balance sheets and dealing with the realities of mounting regulation and Government scrutiny; most existing institutions are in anything but expansionary mode. Is the door therefore open for new, well-capitalised contenders, unencumbered by unprofitable legacy assets who are able to offer a fresh alternative to the established banks? New entrants could come from existing brands in the UK or from overseas players.

Notwithstanding market conditions favourable for new entrants and strong cross party political support for promoting competition, the process of launching a new bank remains a costly and complex undertaking. Only the strongest, most serious new entrants will succeed in expanding into full banking services and tackling the established banks head-on. Investment is significant in the short to medium-term, not just due to the large start-up costs and high capital requirements, but also because of the need to attract depositors and 'buy' market share. However, unencumbered by unprofitable legacy assets, new entrants would be free to price their products competitively. This would be good news for savers.

For borrowers, as credit becomes increasingly more expensive and lenders apply a more sophisticated risk-management model, a group of 'near prime' customers could be left under-served, or even excluded, from traditional credit sources. These customers may well be better-served by a more accessible, 'Peoples Bank'-styled new entrant with which they are likely to feel more comfortable. From an operational perspective, the upfront investment required is extensive, although with rationalisation and restructuring occurring among existing players, non-core divisions, expertise, infrastructure and IT architecture may now become available for sale. If new entrants can acquire ready-made capabilities their time-to-market will be significantly reduced.

Innovation

New technologies, combined with the current pressures on profitability will serve as a catalyst for change and innovation in the payments industry. Credit card issuers will need to diversify their revenue and reduce reliance on conventional sources such as interest income, penalty fees and PPI. In the short term, new fees, most notably annual or monthly membership fees, will be introduced. In the medium to longer term, the industry will seek to reposition the credit card business model to drive more income from usage, by providing increasingly innovative ways for customers to make payments.

Fees on the cards

The re-emergence of annual fees has been widely predicted for some time. However, issuers have been caught in a game of brinkmanship with no one wanting to move first. During 2009, the industry has gradually started to move towards the introduction of fees. Fees are likely to come from both the higher end of the market, where customers will pay for access to premium benefits, and from the lower end of the market, where more marginal customers will be expected to pay for access to even a basic credit card.

Payment innovations

PwC sees three main categories of payment innovation: contactless cards, prepaid and mobile payments.

Contactless cards
Whilst not a new technology, the number of contactless cards in issue is now growing rapidly. The UK Cards Association estimates that at the end of August 2009 over 4.2 million contactless cards had been issued in the UK, representing a 12-fold increase on the previous year. The UK Cards Association forecasts that by mid 2010 this number will have risen to 10 million.

Critical mass is also starting to build in terms of retailers accepting contactless cards. The UK Cards Association estimates that there are approximately 11,000 terminals now accepting contactless cards in the UK. New acceptance environments, such as taxis, vending machines and public transport will accelerate the use of contactless cards.

For retailers, the benefits of contactless cards come primarily from three areas:

Faster payments: There is no customer verification or authorisation for the majority of contactless transactions, hence significantly improving efficiency at the point of sale.

Increased sales volume: With customers no longer constrained by the cash in their pocket, it is expected that contactless cards will increase average transaction values.
Given the convenience of using contactless cards, average transaction frequency is also expected to increase.

Reduction in cost: Contactless cards offer a number of potential cost savings for retailers including; reduced cash shrinkage (through reduction in theft and fraud), reduced staff costs for back-end reconciliation and improved efficiency at the point of sale

Prepaid cards
Outside of more niche markets such as unbanked consumers, currency exchange, and closed-loop retailer gift cards, prepaid cards have struggled to achieve the scale and margins required to have a meaningful impact on the consumer credit industry. However, as consumers become increasingly resistant to taking on more debt this could be about to change.

In partnership with NatWest, O_2 announced a move into financial services with the launch of two prepaid cards. One, the Load & Go card, is targeted at the youth market while the other, the Cash Manager card, is aimed at adult users. Users receive text messages updating them on usage and available credit. The cards have been positioned towards helping customers stay in control of their finances.

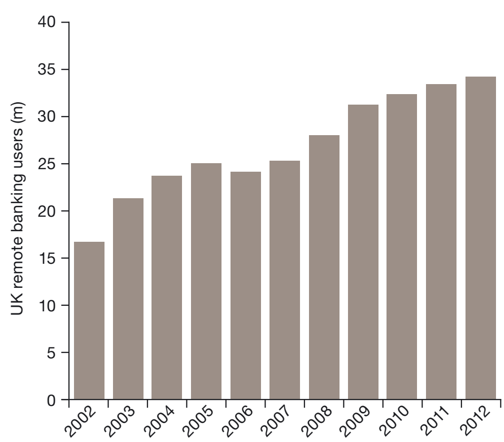
The economics of the O_2 card are enhanced by encouraging customers to top-up their cards and phones online, hence lowering the cost of mobile phone top-ups (from O_2's perspective). The industry will watch the progress of the O_2 card with interest to establish whether prepaid cards have a bigger role to play in the payments industry.

Upwardly mobile?
Mobile banking has amassed a significant following in developing economies over the last five years and has become a core feature of banking and payments in these markets. While there have been cautious steps towards a mobile banking market in the UK, customer adoption has been slow. There is a strong belief, however, that in time it will grow throughout Europe as it has in Asia and elsewhere.

A number of mobile banking and mobile payment services have been developed for the UK market, but the scale of customer adoption has been relatively weak. The financial services industry has yet to be convinced there is a strong business case for mobile banking, given existing, reliable alternatives in the UK banking infrastructure. The industry believes there is inertia in adoption and roll-out of mobile financial services, compounded further by the difficult current economic climate.

As customer behaviour changes, growth is expected in the use of remote banking channels, including mobile banking. Over the next three years remote banking is forecast to grow at 3.1% annually (Figure 15).

Figure 15: Users of remote banking in the UK



Source: UK Cards Association, PwC analysis

Mobile banking: types and scope

"Mobile banking" is taken to mean a spectrum of transaction types that bypass the need to handle physical cash and, in most cases, involve a mobile phone. However, the concept can be further defined along the lines of banking and payments, with remittances falling in between the two, as illustrated by the table below.

Mobile banking intersects with mobile payments as transactions extend beyond intra-account to inter-account, such as funds transfers between banking customers via mobile phone. These person-to-person transfers do not necessarily need to involve a bank account and represent a step towards mobile payments.

Mobile banking	• Balance checks • Limit alerts • Chequebook orders
Mobile remittances	• Inter-account transfers via mobile internet banking/mobile application-based service • Person-to-person transfers via text
Mobile payments	• Payments over text/mobile internet sites for goods and services • Contactless mobile payments

UK background

The UK took its first steps into the mobile banking space at the start of the century with the launch of basic balance enquiries and text alerts. Over the past decade, some application-based mobile banking services have been launched. However, the UK lags developing economies, since the latter have been able to jump straight from older systems onto more advanced ones.

A number of the organisations PwC has interviewed believed the key constraints to the proliferation of mobile banking in the UK are that the services offered would merely replicate those offered through the existing online banking and ATM network, both of which are widely and reliably available. Such a network makes customers unwilling to pay extra for a proposition that they effectively already have. These factors have consequently meant the prospect of mass mobile banking adoption in the UK is a 'push' rather than 'pull' customer proposition, leaving the onus for its development and hoped for proliferation with the banks and other possible suppliers.

Mobile banking

The fundamental demand side constraints of the UK market have deterred financial institutions from supplying mobile banking solutions and incurring investment costs where there appears to be little likelihood of generating revenues.

However, the industry foresees a more opportune time to enter this market, once customers warm to the idea of using the mobile internet. This is likely to take place when 3G technologies and smartphones enter the mainstream UK market and become widely used. The use of 3G technology on phones is forecast to reach over 20 million subscribers in the UK by 2012, which would represent an increase of about 90% over a five year period.

Mobile payments and remittances

Mobile payments are seen by the industry experts PwC interviewed to present greater potential than mobile banking. However, there is an acknowledgement that until this market gathers momentum, there is limited scope to capture value. There is, however, existing demand and growth in the UK outward remittances market, which is believed to offer fresh opportunities for mobile payments providers.

The World Bank believes that unrecorded remittances sent through unofficial channels could be many times the volume and value of the known recorded remittances. This implies a significantly larger market that could be captured given an appropriate proposition.

The UK's main remittance destinations are to African and Asian countries. There are opportunities to capitalise on growth if banks can engage with mobile operators and mobile payments services providers to offer innovative remittance methods for migrant populations who may be underbanked or unbanked.
The remittance market is expanding rapidly and has clear customer segments and demands.

While mobile banking in the UK has limited growth potential in the short-term, mobile payments are likely to take off. Mobile money remittances may present the greatest immediate opportunity to capture revenues. Whilst market players have yet to discover a product proposition that stimulates significant consumer demand, early positioning could be vital to take advantage of potential future opportunities.

The impact on consumers

As discussed throughout this report, the supply of credit has been affected by factors such as mounting bad debts, continued regulatory pressure, increasing capital requirements and funding constraints. It is the effect that these factors have had on lending profitability, rather than a fall in demand for credit, that has constrained supply.

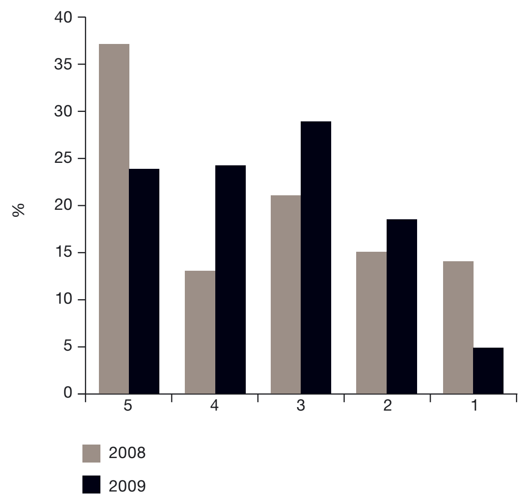
In 2009, the trend towards 'financial repair' among UK consumers has suppressed the demand for credit and, therefore, limited the impact of the reduction in lending capacity. However, as the economy moves out of recession, demand for credit is likely to increase. In the short-term, the supply-side is unlikely to meet this demand. Lenders have already responded to the pressure on profitability with stricter credit scoring criteria, as their customer focus moves increasingly from quantity to quality. Acceptance rates on lending products will continue to fall as the majority of lenders pursue a more cautious approach. This reduction in the availability of credit, and the resulting gap between demand and supply, will be felt across the population, with consumer groups such as younger people with limited credit history and those in the 'near prime' category being hit the hardest.

These borrowers will struggle to obtain credit from mainstream lenders and may be forced to resort to doorstep lenders, loan sharks and pay-day loans to tide them over. This sector of the market may provide a good opportunity to new entrants not encumbered by the issues faced by current lenders, particularly around bad debt.

In addition to this supply-side shortfall, credit will become more expensive as lenders attempt to claw back revenue lost as a result of economic and regulatory pressures. This will be felt through increased APRs, an introduction of fee-based lending, or both.

PwC's Credit Confidence survey found that under a quarter of the sample surveyed believed that their cost of credit will increase over the next 12 months (Figure 16).

Figure 16: I believe my own cost of borrowing will increase in the next 12 months



Note: 1=strongly agree, 5=strongly disagree

Source: YouGov, PwC Credit Confidence survey

However, in contrast to the survey results, PwC believes that the cost of borrowing is likely to rise for all but a small minority, indicating a significant consumer expectation gap.

Whilst the initial effect on consumers of current market conditions will be a reduction in the availability of credit and an increase in its cost, consumers should experience some benefits in the medium to longer term. The increasing emphasis for lenders on profitability over volume will lead them to seek to maximise value from a smaller, core group of customers. In this environment, brand loyalty will be rewarded as lenders place a continued emphasis on retaining more profitable customers, rather than concentrating their resources primarily on growing the size of their customer base.

In addition, pressures on profitability will drive lenders to innovate to establish a more sustainable business model. Consumers will benefit from increasingly innovative payment solutions and lenders will look for ways to differentiate their credit product offering from those of their competitors, leading to an increase in product choice. Once a semblance of equilibrium has been restored, borrowers should also be left with more manageable levels of debt.

About PricewaterhouseCoopers

The consumer credit market is undergoing a period of change, demanding participants to be more competitive and innovative. The Consumer Finance team of PricewaterhouseCoopers is a leading adviser in the consumer credit market. We offer a perspective derived from working with all types of market participants across multiple functions, including major banks, card issuers, retailers and other non-financial institutions, specialist lenders and brokers. The team has extensive experience advising and assisting clients with:

- Strategy and business plans
- Market and economic analyses
- Partnership strategies and contract negotiations
- Debt portfolio strategies
- Valuations
- Regulation and the business response
- Due diligence
- Transaction and investment decisions

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