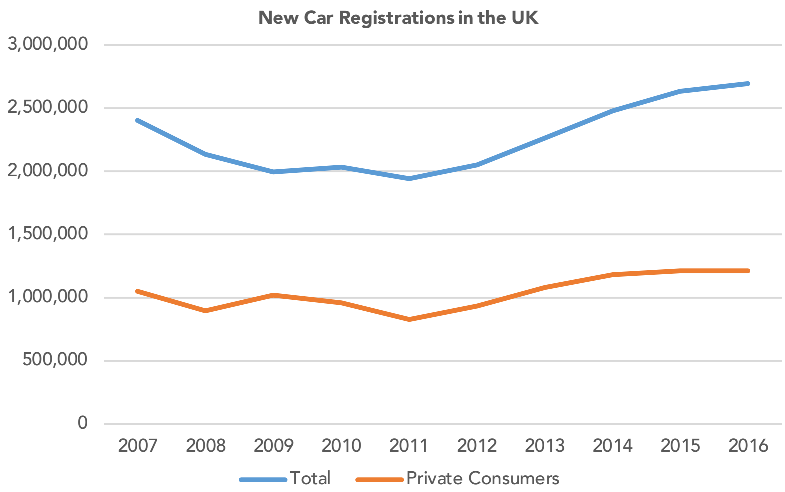
UK CAR FINANCE – PERSONAL CONTRACT PURCHASE (PCP) SPOTLIGHT

London, 2 March – Personal contract purchase (PCP) agreements have been increasingly popular in UK car finance over the past few years. Primarily because they represent a cheaper, monthly instalment, means to get a new car. They have been used by car manufacturers, through their financial subsidiaries, and dealers to reignite the new car market during the 2008/2011 financial crisis and are now being used to push repeat purchases either at, or prior to, the end of contracts, leading the UK new car market to achieve record levels. However, it should be noted that risks for lenders may be also increasing.



Source: Society of Motor Manufacturers and Traders (SMMT).

PCP agreements are rental agreements were the lender is the owner of the vehicle and the customer/borrower pays monthly rentals equivalent to the repayment of the car price minus the deposit paid initially and the expected commercial value of the car at the end of the contract ("guaranteed future value", mostly known as "balloon payment") plus interest (some contracts may also include servicing and maintenance schemes and insurance). PCP agreements terms are typically three to four years. Postponing a higher value (the balloon payment) for paying at the end of the contract, or returning the car, allows monthly payments to be significantly lower compared to other finance or lease schemes.

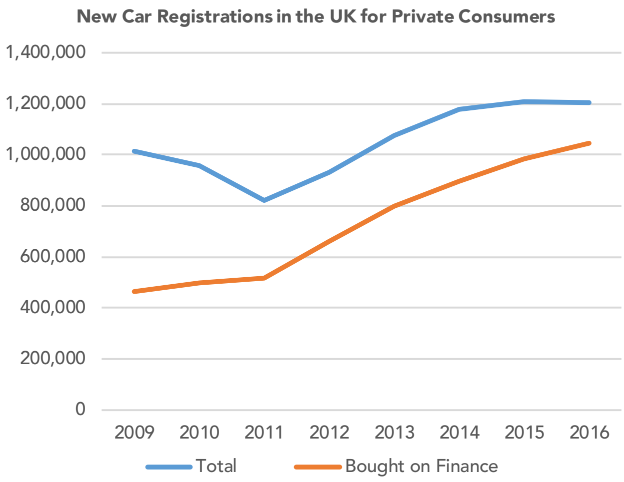
At the end of the contract the costumer/borrower has three options:

- buy the car, paying the balloon payment; or
- hand the car back and walk away; or
- trade the car in by using any existing "equity" (when the car is worth more than the balloon payment agreed) to fund the deposit for a new PCP agreement.

Trading the car for a new car at, or even prior to, the end of the contract has been the most common consumer choice, as the car values at the end of contracts have been higher than the balloon payments agreed. However, if the car value is lower than the balloon payment, the customer/borrower is most likely to hand the car back and walk away.

To define the balloon payment the lender asks the borrower to specify a mileage limit and at the end of the contract the car is expected to be in a saleable condition, only with normal wear and tear. So, at the end of the contract the borrower may have to pay damage and or over-mileage charges, unless he buys the car.

PCP agreements were first introduced over a decade ago, representing 53% of new cars bought on finance by personal consumers in 2009 and 76% in 2015, boosting the share of car finance on all private new car sales to 86.6% in 2016 from 45.8% in 2009. More recently PCP agreements are also becoming increasingly available for used cars, typically only for up to 3-years old (also with km on the clock limits), having already represented 39% of used cars bought on finance by personal consumers in 2015 (up from 26% in 2013 and 12% in 2010).



Source: Society of Motor Manufacturers and Traders (SMMT).
Finance & Leasing Association (FLA).

INCREASED RISKS FOR LENDERS

Increase of PCP agreements may represent higher risks for lenders because consumers are "buying" a new car more often, which means that used cars available for sale are increasing, which puts pressure on prices of used cars to fall, and a potential decrease in used cars values will lead to an increase of returned vehicles for lenders at impaired value (i.e. an increase in the Residual Value risk). This may be exacerbated in cases of deteriorating economic conditions, or as a minimum due to worst used car sales conditions together with increased delinquencies and car returns, while in the medium term a downturn in the economy may lead to stronger sales of used cars and resume used cars prices.

Other risks may be the significant increase of interest rates over the next few years. While PCP's monthly payments are fixed at fixed interest rates, families may choose to not pay and return the car due to increased payments in residential mortgages or other commitments.

ABS ANALYSIS

From the perspective of credit ratings for Asset-Backed Securities (ABS) transactions for auto loans or leases, ARC will incorporate the increase in the Residual Value (RV) risk into its analysis, notably in the review of originator's RV setting policy, and therefore ARC may increase stresses applied to quantitative analysis to ensure that the level of credit enhancement in the structure is adequate for the increased RV risk.

Despite the increase in the RV risk for PCP lenders, it should be also noted that compared to other car finance schemes in the UK PCP agreements have typically a lower risk for lenders due to the Voluntary Terminations (VT) risk that auto transactions are exposed to, under the Consumer Credit Act: an obligor is entitled to enter into a voluntary termination after paying 50% of the initial loan amount and return the car to the credit provider, provided the car has been kept in good condition. Because of the balloon payment, under PCP agreements the 50% repayment is typically achieved more closely to the end of the contract and, thus, VT risk is typically lower.

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