



# An Overview to Sub-prime Lending in Western Europe 2007

Sub-prime lending is a small but growing phenomenon across Western Europe. Indeed, a number of specialist players are active in the market and some mainstream banks are now lending to those with a small history of credit problems. But how are bank attitudes to sub-prime lending changing and which countries hold the most potential for the future?

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## CHAPTER 1 INTRODUCTION

Sub-prime lending – on mortgages, personal loans, and credit cards – is a small but growing phenomenon across Western Europe. Indeed, a number of specialist players have become active in several markets and some mainstream banks are lending to those with a small history of credit problems. As a result, bank attitudes to sub-prime lending are gradually changing.

This report looks at the state and development of sub-prime lending across Western Europe. It analyses factors that are currently inhibiting growth in particular countries and studies some of the particularly attractive emerging sub-prime markets in detail. It also profiles some of the sub-prime specialists in Europe and discusses the challenges and future of sub-prime lending.

### Scope of the report

This report focuses on bank attitudes and the development of sub-prime lending across Western Europe. The findings in this report are supported by Datamonitor's **European Branch Manager Survey 2006** conducted during September to November 2006. Datamonitor interviewed 500 branch managers across Europe to gauge their views on sub-prime lending, lending criteria and the degree to which this market is changing. Interviews were evenly spread over the fifteen countries covered in this report (that is, Western Europe) and were carried out with leading high street retail and savings banks. The methodology behind the survey, and the underlying data that accompanies the graphics in this report, can be found in the Appendix.

### Definition of sub-prime individuals

Sub-prime individuals are at the least worthy end of the credit spectrum. These individuals are rejected by mainstream lenders for a diverse set of reasons, such as bankruptcy, a history of mortgage or consumer credit arrears, or other poor records of payment in their credit history, such as bounced checks, unpaid household bills, and court orders, among others.

## Who is the target reader?

This report is essential reading for all financial services organizations and other organizations present in or thinking of entering the sub-prime lending market. Specifically, this report is targeted at institutions looking to have a thorough overview of the scope and context of sub-prime lending in Western Europe.

Within these organizations the following will find this report invaluable: directors, business development managers, business analysts and researchers, strategic planners, product managers and marketing managers.

## How to use this report

Following the **Introduction** chapter, this report is structured into four further chapters:

- **Chapter Two: The Development of Sub-prime Lending in Western Europe** – this chapter charts the development of sub-prime lending in Western Europe, and any factors that can inhibit its growth in general;
- **Chapter Three: The State of Sub-prime Lending across Western Europe** – this chapter considers the varying bank attitudes to sub-prime lending, discusses some of the particularly attractive emerging markets in detail, and profiles some of the specialists already involved;
- **Chapter Four: Conclusions** – this chapter considers the future of sub-prime lending in Western Europe, as well as the challenges and risks for lenders over the next few years;
- **Chapter Five: Appendix** – this chapter provides supplementary data tables, further information regarding Datamonitor's products and services and contact details for the Retail Banking team.

## CHAPTER 2 THE DEVELOPMENT OF SUB-PRIME LENDING IN WESTERN EUROPE

### Introduction

Sub-prime lending – on mortgages, personal loans, and credit cards – is a small but growing phenomenon across Western Europe. Indeed, a number of specialist players have become active in a number of markets and even some mainstream banks are lending to those with a light history of credit problems. This chapter looks at the development of sub-prime lending in Western Europe in its historical context, and any factors that can inhibit the sector's growth in general.

### Sub-prime individuals are at the least worthy end of the credit spectrum

The sub-prime lending sector refers to individuals who are at the least worthy end of the credit spectrum. These individuals are rejected by mainstream lenders for a diverse set of reasons, such as bankruptcy, a history of mortgage or consumer credit arrears, or other poor records of payment in their credit history, such as bounced checks, unpaid household and utility bills, and court orders, among others.

As lending to sub-prime individuals is a more risky venture than lending to mainstream customers, a higher rate of interest is charged to cover the extra risk. Unsurprisingly, lending to the sub-prime sector requires considerable bespoke skills and extensive experience with risk-based pricing. As a result, it is not a niche market that all banks are equipped to enter. In many cases, specialist lenders will cater to this market, focusing their skills on this sector alone.

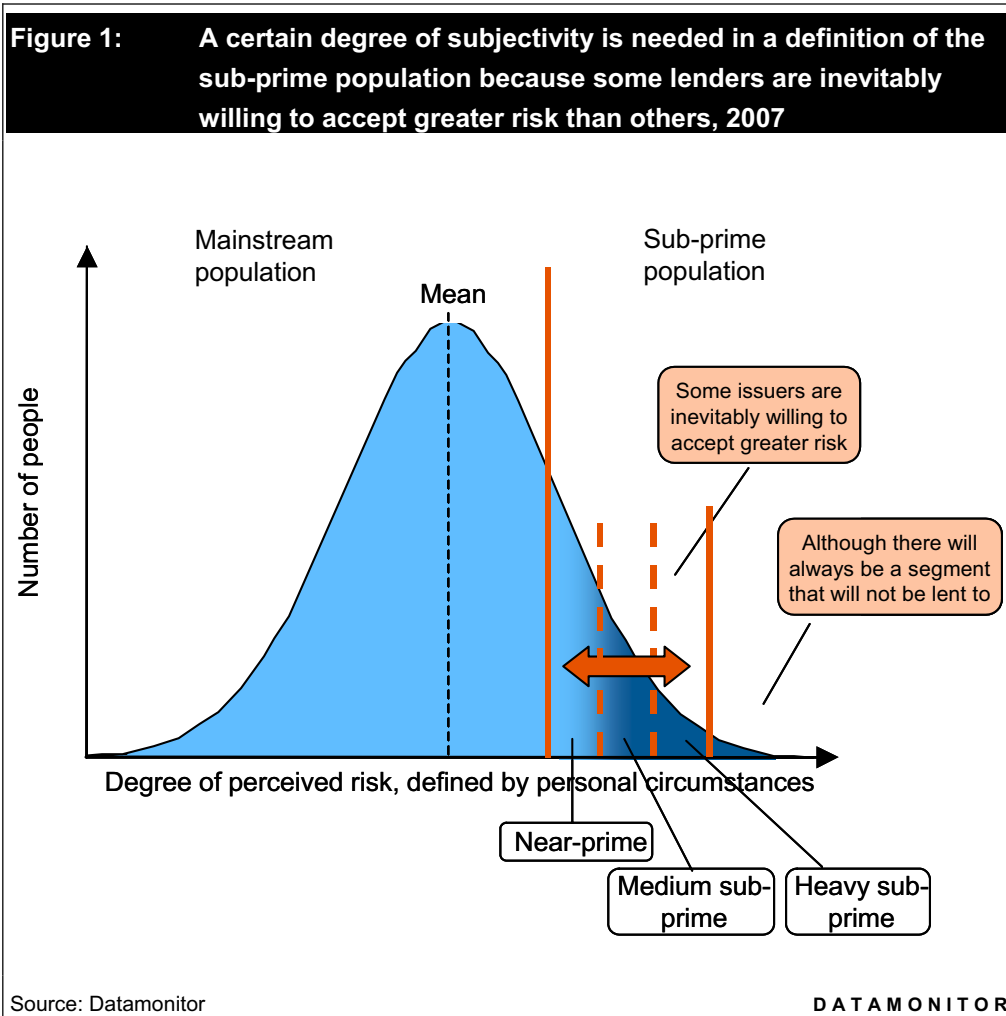
### *There are numerous degrees of sub-prime*

There are a number of degrees to which individuals are sub-prime. Exact definitions of each degree are hard to come by as each lender assesses an applicant differently and could consider them to be in different risk groups. Moreover, as the sub-prime lending market has developed, lenders have become more sophisticated and increasingly use a greater number of risk groupings.

However, in some markets, such as in the UK, it is generally possible to identify three broad groupings (as per independent price comparison site *Moneyfacts* definitions):

- **near-prime** – those with minor credit history problems and near the prime population in terms of credit-worthiness. For example, these customers tend to have less than €3,000 or €4,000 in County Court Judgements (CCJs), one to two arrears in the last year, no bankruptcies or one that has been discharged over a year ago, or no IVAs or one satisfaction over a year ago;
- **medium sub-prime** – those with a medium degree of credit history problems. These customers tend to have CCJs around the value of €5,000 to €7,000, two to three arrears in the last year or less, no bankruptcies or one in the last year or less, or no IVAs or one satisfaction in the last year or less;
- **heavy sub-prime** – those with substantial credit history problems. These customers tend to have a greater value of CCJs, as well as more arrears, a more recent bankruptcy or continuing IVA satisfaction, depending upon lenders.

These groups are graphically highlighted below.



***Moreover, sub-prime individuals are part of a broader set of non-standard individuals***

Sub-prime individuals are not the only type of individuals that are routinely rejected by mainstream lenders. Indeed, depending on the country, other individuals such as the self-employed (depending upon proof of income) and those who claim income support, among others can be routinely rejected. However, for clarity's sake, this report deals solely with individuals who fall into the sub-prime category.

Readers requiring more information on the UK's non-standard and sub-prime lending market are directed to the following suite of reports: *UK Non-standard and Sub-prime Consumers 2006*; *UK Non-standard and Sub-prime Mortgages 2006* and *UK non-standard and Sub-prime Consumer Credit 2006*. Forthcoming reports include *UK Sub-prime Mortgages 2007* and *The UK Home Collected Credit Market 2007*.

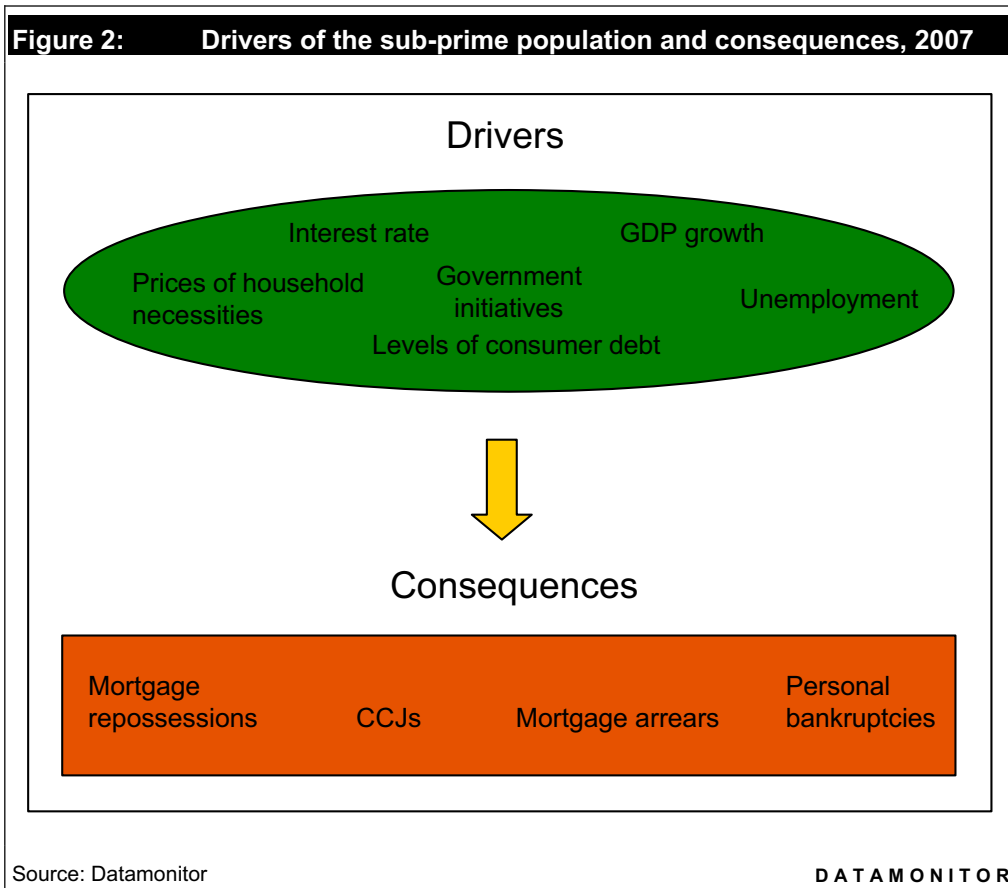
### *There are a number of drivers that affect the size of the sub-prime population*

There are a couple of major drivers that affect the number of people classified as sub-prime:

- **macro-economic conditions** – such conditions are the underlying, and therefore the most important, drivers of the sub-prime. For example, during a recession the sub-prime population grows as more individuals lose their jobs and are less able to cope with their financial commitments. Indeed, individuals are also more likely to default on their mortgage, more likely to go bankrupt due to business failure or another catastrophic event and more likely to gain a record of CCJs. During a period of buoyant economic conditions the opposite is true and hence the sub-prime population contracts (although even during this period as some individuals are allowed to borrow more than that which is sustainable, the seeds are being sown for an increase in the sub-prime population when conditions worsen);
- **government initiatives to tackle financial exclusion** – governments in many countries work towards improving financial awareness and fiscal prudence among their populations. Initiatives such as promoting financial literacy, encouraging savings among disadvantaged households and providing help when things go wrong are all ways of reducing the number of sub-prime individuals, as more will be prepared to cope with their financial commitments during difficult times.

For example, in the UK, the Government launched the Savings Gateway initiative in April 2001, with the aim of encouraging saving among low-income households. Such savings would obviously benefit them in the long-term but could also benefit them during times of extraordinary financial difficulties, and would help to avoid accumulating arrears or defaults. Government initiatives can therefore also, if significant enough in size, affect the sub-prime population.

These drivers and their consequences are displayed in the graphic below.



## Sub-prime lending began in the US during the early 1990s

Sub-prime mortgages were the first product to become available

The advent of sub-prime lending began in the US during the early 1990s. As the lending market became increasingly competitive and saturated, lenders began to look to as-yet-unexplored niche markets that would give them higher profit margins and a greater pool of customers. Indeed, development of the sub-prime lending sector is often an indicator of the extent of development of a particular lending market. Generally speaking, the sub-prime market is only developed once the mainstream market heads towards saturation level. Lenders at this point look for other sources of revenue, particularly high margin niche sectors such as the sub-prime lending market. Thus, generally speaking, a developed and competitive sub-prime market will point

towards an already highly developed mainstream lending market. Indeed, during the early 1990s a few US lenders began offering mortgages to sub-prime individuals. Other products gradually followed.

In fact, mortgages tend to be a natural product to offer to higher risk individuals, as the loan is secured against the property. As such it is not surprising that mortgages were the first sub-prime product to become available in the US. However, sub-prime lending via personal loans (a very small market) and credit cards has also become relatively common, but necessitates particularly sophisticated risk modelling as there is no security on the loan.

### The mid 1990s saw the inception of sub-prime credit cards

During the mid 1990s – with many of the obvious niche credit card markets such as premium cards and affinity partnerships reaching saturation point – sub-prime customers represented one of the few remaining opportunities that was still relatively unexplored in the US credit card market.

Specialist issuers, such as Capital One, Provident, Metris and NextCard led the way in the market, enjoying strong growth and good profit margins at the beginning. As competition in the market began to intensify in the late 1990s, issuers started to advertise their products heavily, using such slogans as “guaranteed approval”, “no employment verifications” and “no credit turndowns” to target non-standard and sub-prime individuals.

Yet as it turned out, many specialists ended up going too sub-prime and had to close down. Indeed, with strong economic conditions and low unemployment, credit card delinquency rates even in the sub-prime market remained relatively low in the 1990s. However, this all changed in 2001 when the US economy headed towards recession. As will be discussed in Chapter Four, lenders in this sector must be aware of its risks.

### **Sub-prime lending then appeared in the UK**

#### Sub-prime lending made its way over to the UK during the mid 1990s

Developments in the UK retail banking market tend to follow that of the US. Indeed, following on from the launch of sub-prime lending in the US, the sub-prime mortgage

market began to develop in the mid 1990s in the UK as a result of deregulation, the prevalence of credit-impaired individuals and the entry of US players. The market has since expanded significantly, and these mortgages now offer a wide variety of choices, including different repayment options, interest rates, and payment holidays, among other options that were first introduced in the prime mortgage market.

Moreover, the UK sub-prime mortgage market's competitive structure has changed over time as it has become more developed. Once populated by a small clique of specialist players, which largely maintained autonomy from high street lenders and other major financial institutions, the structure of the market has undergone (and is still undergoing) a marked change in that mainstream lenders are playing an increasingly important role, and investment banks continue to enter the market. Nevertheless, while there have been a host of new entrants into the market, specialist players continue to dominate.

On a side note, the sub-prime mortgage markets in Canada and Australia have also become well-developed, though the Australian market still lags behind the UK in terms of development.

### *Sub-prime credit card lending is also present now*

The sub-prime credit card market began to develop in the UK soon after its expansion in the US. Mainstream lenders do not, by definition, lend to sub-prime customers, often because they do not have the detailed credit scoring abilities to accurately assess the risk involved, or the flexibility required to price products accordingly. However, in reality, there are several high street issuers in the UK market that are currently active in the sub-prime market through either their own brands or those of non-standard and sub-prime specialist subsidiaries, including Capital One, Citibank, HSBC and the Royal Bank of Scotland. Specialists are also involved, such as SAV Credit and Vanquis Bank.

Moreover, there remains untapped potential in the sub-prime credit card market in the UK as there continues to be fewer competitors and higher revenue opportunities than in the saturated mainstream market, as well as a rising number of sub-prime consumers as the UK faces a tougher economic environment.

*Even sub-prime personal loans are available, though to a small degree*

Sub-prime personal loans (around a value of £1,000 to £3,000 (€1,000 to €€4,500)) have also become available in the UK market, though on a small scale. Besides Cattles and London Scottish, very few lenders operate in this segment. To demonstrate the small size of the market, Cattles' unsecured personal loan gross advances in 2005 totalled £237 million (€344 million), not all of which was sub-prime.

## The UK is Europe's most developed sub-prime lending market

The UK now leads Europe in terms of sub-prime lending. Its sub-prime lending market has become substantially developed, with mortgages, credit cards and personal loans all available to the sub-prime population. Moreover, there are a range of lenders in the market, with some that are particularly competitive (such as those competing in the mortgage market). Indeed, with little competition in the early stages of the market's development, potential rewards to lenders were significant. However, high profits have attracted a greater number of lenders which in turn has led to margin compression as price competition has increased.

*Moreover, securitization is becoming ever more common*

Securitization, for mortgages in particular, is becoming increasingly common in the UK (having first begun in the US). Although the mortgage securitization market in the UK is relatively small in relation to the total mortgage market, the UK has developed a sound framework for mortgage-backed securities (MBS) and today has the most advanced mortgage-backed securities market in Europe.

The infrastructure in the UK, unlike in many other European countries, is fairly well suited for asset securitization. As a common law jurisdiction, different securitization structures have been able to evolve relatively free of legal restrictions, unless expressly prohibited by existing statutes.

In fact, securitization is still very much associated with the specialist and sub-prime market in the UK. Indeed, all of the prominent players in the specialist mortgage market (many of them owned by investment banks) – including the likes of Platform Home Loans, Preferred Mortgages, GMAC-RFC and SPML – use securitization as their main financing tool. However, mainstream lenders such as Northern Rock, Abbey and HBOS are also very active in the market now as well.

## **Sub-prime lending is now developing gradually in the majority of Western European markets**

There are a number of factors that can hinder the development of this type of lending

While the development of sub-prime lending is linked to a competitive and often saturated mainstream lending market, there are a number of factors that also have to weigh in the right direction. Below is a list of factors that can sometimes hinder a market's sub-prime development, along with some examples of where they actually do:

- **size of the sub-prime population** – while all the other variables may be right for sub-prime lending, the existence of a sizeable sub-prime population is crucial. Having a large enough sample of sub-prime individuals will enable lenders to attract a big enough pool of customers by which to make a profit;
- **lender attitudes and criteria** – lender attitudes are one of the most important factors affecting the supply of credit and thus the development of sub-prime lending. If lenders tend towards a conservative view of lending they will generally maintain strict criteria and not push sub-prime credit products as much they could. As a result, the development of sub-prime lending will be slower or non-existent;
- **regulatory climate** – both the rule of law and regulation in a country form lenders' sentiment of the future certainty of their lending business. The quality of a country's legal institutions plays a major role in making the possibility of sub-prime lending a reality. Indeed, lenders are generally less willing to offer credit to sub-prime individuals in countries where it is time-consuming and costly for them to recover defaulted loans. For example, in Italy, the legal system makes it difficult to recover against defaulted debtors, and repossessions require a lengthy and costly procedure. This has served and continues to serve as a barrier to the development of the sub-prime market.

In terms of regulation, some countries have greater consumer protection laws than others, which can lead to differences in competition across countries. For example, whilst some countries maintain usury ceilings – which can make it difficult for sub-prime lenders to supply credit at a

commensurate price for risk – in other countries lenders are allowed to charge interest rates of their choosing. Other examples include limits on door-to-door selling, or the use of credit bureau data, among others. For example, in Belgium, data protection laws are relatively strict and interest rate ceilings exist, which has affected the rate of its sub-prime market's development;

- **extent of competition** – the degree of overall competitiveness differs from one market to the next, which will affect the development of sub-prime lending. Some markets are characterized by a small number of large suppliers. In some cases, these lenders can dominate market share – hardly an example of perfect competition. In addition, a high concentration of large suppliers may lead to oligopolistic behavior. Yet other markets are highly competitive, characterized by a high degree of innovation and aggressive tactics. As discussed, such a market will encourage sub-prime lending, as specialists or banks will eventually enter the sub-prime market to take advantage of higher margins and a new pool of customers. As such, the extent of competition can have a great effect on the absence or presence of sub-prime lending;
- **information gathering** – lenders assessing sub-prime applications need as much data as possible on an individual in order to accurately price for the risk they are undertaking. As a result, credit bureaux play an important role in determining the potential growth of sub-prime lending. Information sharing through credit bureaux helps lenders manage credit risk. Credit bureaux also help to encourage competition, as the competitive advantage enjoyed by large banks with extensive proprietary data on their existing customers is lowered, allowing room for new entrants.

For example, in France, lenders are limited in their management of risk because of the lack of sufficient credit information on consumers. *Banque de France* only began to provide negative data in 1989 and privacy laws forbid the accumulation of positive data so the bank only gives arrears and default information. Furthermore, once a bill is paid, the debtor's name is removed from the list, and even if the bill is not paid, their name is removed after five years. This has meant that new lenders entering the market have a distinct disadvantage over long-time established lenders with their own databases;

- **economic condition and future certainty** – the economic condition of a country's financial system affects the willingness and ability of banks to

extend all types of credit. Lenders will not be as willing to lend in countries where there is a high degree of economic volatility or financial crisis; rather, lenders seek countries characterized by a stable financial system;

- **government provision of credit/help to sub-prime individuals** – some governments give subsidies to or help individuals who have trouble accessing mainstream credit. If such government aid goes to the extent that sub-prime individuals are helped enough by the government, then there would be no incentive for lenders to develop or enter the sub-prime market;
- **distribution** – the way in which credit is distributed can make an impact upon the development of sub-prime lending. For example, sub-prime mortgages tend to be distributed via intermediaries. As such, for sub-prime mortgage lending to be able to develop in general, intermediaries need to play a substantial role in the market in the majority of cases.

### The majority of Western European retail banking markets are seeing an expansion of sub-prime lending

Sub-prime lending is gradually gaining momentum in Western European markets. Indeed, just as sub-prime lending in the UK followed the US, so the rest of Western Europe is slowly following the UK. Many countries have significantly deregulated their financial markets, which make a more competitive and sophisticated lending market possible. Mike Culhane, chief executive of The Oakwood Group in the UK, commented in 2005,

*“The US has the most mature sub-prime market in the world but other countries are following in its footsteps. Sub-prime is already an important part of the mortgage markets in the UK and Australia and will in time be a feature of markets the world over.”*

The following chapter builds on this chapter’s analysis by studying the level of development across Western European countries, as well as discussing particularly attractive markets for the future.

## **CHAPTER 3 THE STATE OF SUB-PRIME LENDING ACROSS WESTERN EUROPE**

### **Introduction**

This chapter builds on the largely historical content of the previous chapter to examine the state of sub-prime lending across Western Europe, highlighting which markets are developing quickly and which hold untapped potential. Moreover, it examines bank attitudes to sub-prime lending and profiles a number of sub-prime lenders in detail.

### **Sub-prime lending in Western Europe still remains small on the whole**

The majority of countries only have a few lenders and specialists serving the market

While sub-prime lending is expanding gradually in Western Europe, it is still a small segment wherein the majority of lenders are not involved. Moreover, there are not a substantial number of specialists known for this type of lending yet in many markets.

To demonstrate this situation, the table below lists the major and some minor lenders/specialists most likely to be active in the sub-prime lending market for each Western European country covered in this report. It is important to keep in mind that for some specialists, it was very difficult to verify whether they did lend to sub-prime individuals or just mainstream specialist lending. Moreover, in some markets mainstream lenders may be offering near-prime credit, but this information is not always available.

**Table 1: A sample of lenders likely to be offering credit to sub-prime individuals by country, April 2007**

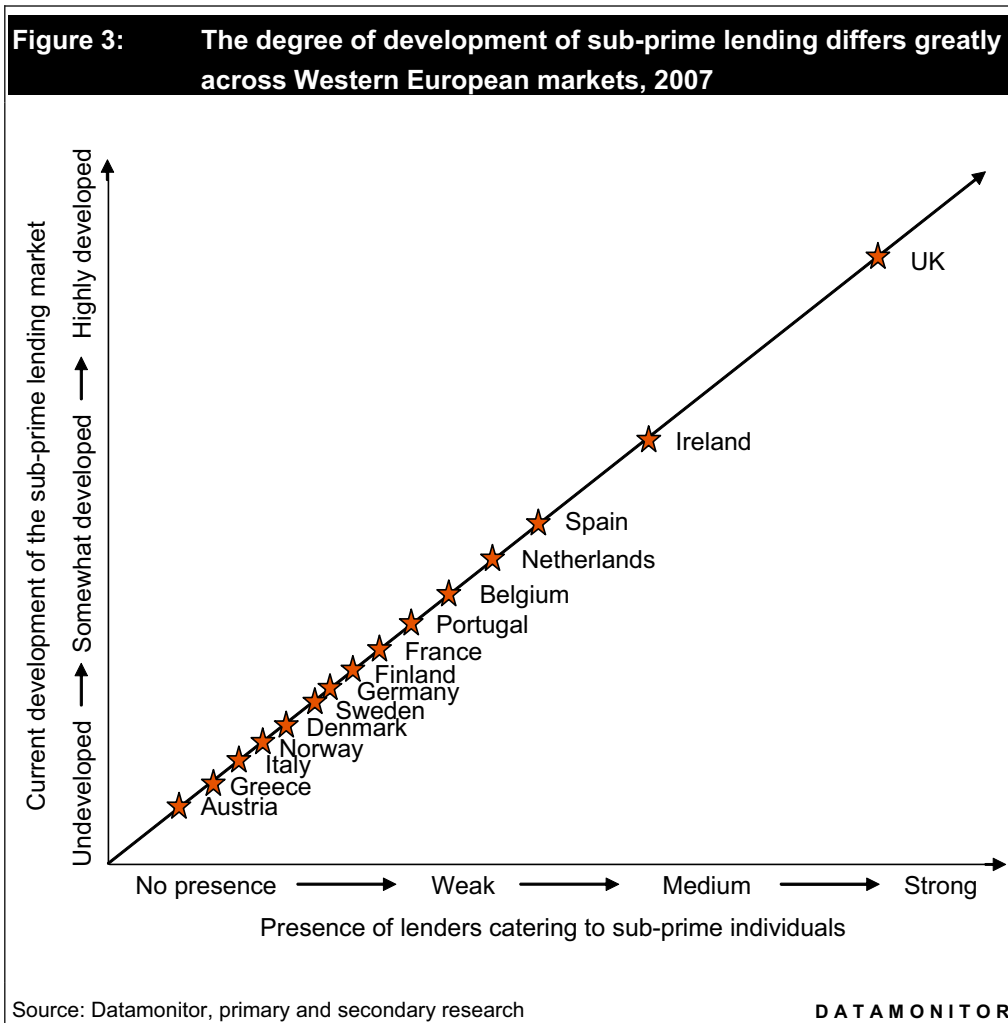
<b>Lenders offering credit to sub-prime individuals</b>	
Austria	GE Money Bank
Belgium	Citibank, Europabank, GE Money
Denmark	Holm Finans, Dansk Bolig Finansiering, Omega Lån, Realpantebrev.dk, Alcor Finans, Hos Lån & Finans A/S
Finland	GE Money, Mobile Credit
Germany	GMAC-RFC, GE Money Bank, Citibank, Bon-Kredit, Creditolo, Kredit1a
France	Médiatis
Netherlands	DSB, Stadsbank, Krediet Bank, Poskrediet, GMAC-RFC, Sparck Hypotheken
Ireland	GE Money, CitiFinancial, HFC Bank, Start Mortgages
Italy	GE Money
Norway	GE Money
Portugal	Banco Primus, Cofidis, Médiatis
Spain	Losada, Cofidis, Credifácil, GE Money Bank, Unión de Créditos Inmobiliarios, GMAC-RFC
Sweden	Bluestep, Freedom Finance
UK *	Birmingham Midshires, GMAC-RFC, GE Money Home Lending, Kensington Mortgage Group, Platform, Cattles, London Scottish, Barclaycard (near-prime), Citibank, Capital One, Vanquis Bank, SAV Credit

Notes:  
 Lenders involved are in no particular order of importance. Not every lender in each market is mentioned.  
 \*The UK has a very large number of specialists in the sub-prime market, the majority of which are not included here. Many high street players in the UK own sub-prime and non-standard specialists.  
 Source: Datamonitor, lender websites, primary and secondary research

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### The degree of development differs across these markets

While most markets appear to have at least a few lenders involved in the sub-prime lending sector, some markets are more developed than others. The graphic below presents the fifteen countries covered in this report and the extent to which sub-prime lending is present in their respective retail banking markets, on a scale from 'no presence' to 'strong' presence, and the extent of the market's development on a scale from 'undeveloped' to 'highly developed'.



Each country's sub-prime lending market is discussed in greater detail below.

*Austria's sub-prime lending market is highly undeveloped*

Sub-prime lending is highly undeveloped in Austria. There are very few lenders operating in this segment and mainstream lenders stay almost completely away from it, with very few offering credit to near-prime individuals. Mainstream banks have very strict lending criteria and it is unlikely that this will change in the short-term.

While Austria has been open to competition from other EU financial institutions since 1993, foreign banks have not entered Austria on a significant scale. This is due to the thin margins that the Austrian banking market operates on and Austria's small size

overall – thus making entry into the mainstream market largely unappealing. Yet GE Money Bank has made its presence felt, and there remains a ‘gap’ for sub-prime lending, though an interest rate cap does exist.

*Belgium’s sub-prime lending market is slowly developing*

With a high degree of consolidation in the market, Belgian mainstream banks maintain conservative lending criteria, with no sub-prime lending. In fact, the market for sub-prime lending is limited by Belgium’s strict consumer protection laws. For example, there is an interest rate ceiling which depends on the amount and duration of a loan. While advertising credit via the press is allowed, making an individual credit approach to a consumer is still difficult as there is a high degree of consumer data protection. Moreover, in 2002, Belgium passed a new law, *la Loi Santkin*, which limits the maximum penalty fees that can be charged by lending institutions. In addition, 2003 saw further legislation which reduces early payment penalties to a maximum of two to three months’ interest, curbing the finance provider’s ability to charge additionally.

Yet a very small number of sub-prime providers exist, such as *Europabank*, although these also cater to mainstream individuals as well.

*The development of sub-prime lending in Denmark is constrained by bank and consumer attitudes*

Sub-prime lending remains diminutive in Denmark, with a limited number of small participating providers. Those providers in the market are small Danish lenders, who offer mortgages (not unsecured loans or credit cards) to customers who are unable to get access to mainstream lenders because of previous arrears, as well as other circumstances.

The sector remains significantly unknown except to those few who are involved in it. This was supported by the fact that the majority of branch managers in Denmark interviewed by Datamonitor remain unaware of any providers in the market. Moreover, sub-prime lending remains significantly tainted by a negative reputation, both on the lender and consumer sides.

*Finland has a small, but reasonably well-known sub-prime lending market*

In line with other Nordic markets, the Finnish banking market remains highly concentrated. Some of the large Finnish banks do accept customers with slight credit arrears, though customers with serious credit history problems are not accepted. There have been foreign entrants to the Finnish market, some who target non-standard individuals, such as those who are self-employed, those without much of a credit history and those with poor credit histories. Indeed, the few lenders who are active in this market are well-known among the banking community, but do not cater specifically towards the sub-prime, but rather target the non-standard population.

*Because of strict interest rate ceilings, there is a small and restricted sub-prime market in France*

Sub-prime lending exists in France to a small degree in France. Indeed, while a few mainstream players (typically finance houses such as *Cetelem*, *Cofinoga*, among others) have started to cater for non-standard customers, sub-prime customers remain largely uncatered for. This can explain the fact that the majority of branch managers surveyed by Datamonitor were not aware of any providers lending to sub-prime individuals.

In fact, strict usury laws set by the *Banque de France* make it difficult for issuers to offer credit to sub-prime customers. Indeed, the *Banque de France* sets usury limits, which are adjusted quarterly, around one third above the average market rate. Usury rates as at 8 February 2007 for fixed and variable rate mortgages were 6.39 and 3.12 per cent respectively. Maximum rates on overdrafts were 20.76 per cent while on personal loans (over the value of €1,524) the rate was 8.44 per cent. Such low maximums make it difficult to lend to customers with poor credit histories, unless the lender has a previous relationship with them.

In reality, it is likely that the mutuals (who draw a large portion of their business from rural communities) will serve the near-prime sector. However, brokers play an important role in the distribution of sub-prime mortgage lending. These brokers are able to secure funding at a low rate, which gives them more room for profit when lending to sub-prime individuals. Such brokers include *CAFPI* (Conseil à l'Accession et au Financement en Prêts Immobiliers) and *ACE*. Meanwhile, other lenders such as *Médiatis* offer credit to sub-prime individuals, as well as offering debt consolidation loans.

Moreover, lenders are limited in their management of risk because of the lack of sufficient credit history information on consumers. *Banque de France* only began to provide negative data in 1989 and privacy laws forbid the accumulation of positive data so the bank only gives arrears and default information. Furthermore, once a bill is paid, the debtor's name is removed from the list, and even if the bill is not paid, their name is removed after five years. Such laws make it difficult for new entrants to compete on par with well-established lenders in terms of getting their risk management models right.

While there are a number of organizations that do lend to the near-prime sector, and perhaps a small proportion to the medium sub-prime sector, many others are not catered for. This has meant that a sizeable number of sub-prime customers still resort to borrowing from illegal money lenders.

#### *Germany's sub-prime lending market has yet to fulfil its potential*

Germany's sub-prime lending market remains underdeveloped due to the poor reputation it engenders as well as conservative lending attitudes. Yet there have been a number of foreign entrants that are now active in the sub-prime market, though on a small basis. There remains significant potential in this market, though an interest rate ceiling exists. Moreover, Germany's laws on repossession, the availability of consumer data and the increasing importance of intermediaries are all positives for prospective entrants.

The opportunity for sub-prime lending in Germany is discussed in greater detail further on in this chapter.

#### *Sub-prime lending is still very much at an emerging stage in Greece*

Sub-prime lending is just at the beginning of development in Greece. When the Bank of Greece revoked maximum limits on consumer credit in 2004, Greek banks and new entrants started to offer a wider variety of lending to individuals. The change in regulation led to more innovation in what has since become a competitive market, yet mainstream lenders continue to maintain strict lending criteria. Indeed, while mainstream lenders may cater towards some near-prime customers, they tend to stay away from more risky lending.

There have been a number of foreign entrants who offer at the very least near-prime lending, yet there remains a large illegal money market in Greece. As such, there

remain good opportunities for the expansion of the sub-prime lending market in Greece, though its credit bureau information remains less than desired.

Sub-prime lending in Greece is expanded upon in greater detail further on in this chapter.

*Ireland's sub-prime market is developing quickly*

Both the mainstream and sub-prime Irish lending markets have become more competitive as both Irish and foreign lenders have entered the market in recent years. Moreover, the mortgage and consumer credit markets have grown significantly on the back of economic and house price growth. Sub-prime lending in Ireland is now following the example of the UK, as an increasing number of lenders become active in the market. Yet saturation is a long way off as significant demand is forecast to continue over the next years.

The fast developing Irish sub-prime lending market is discussed in greater depth further on in this chapter.

*Sub-prime lending in Italy is particularly undeveloped*

There is virtually no sub-prime lending in Italy. Part of this guarded approach can be attributed to the fact that Italian lenders have had little historical experience of lending to near-prime customers. In addition, banks may also be mindful of the large scale defaults that occurred in the mid 1980s and 1990s when banks introduced retail finance without the appropriate risk measurements in place. Moreover, the lengthy and costly repossession laws have undoubtedly made banks more risk averse than they could be elsewhere.

This is particularly true of the mortgage sector, where a weak legal system has but virtually made sub-prime development impossible. Italy is widely held to have the weakest legal system of Western Europe. The system makes it difficult to recover against defaulted debtors and repossessions require a lengthy and costly procedure. In addition, the legal system is perceived as inefficient and subject to corruption, especially in the southern part of the country. Unless the legal system can be improved upon, this will continue to make sub-prime mortgage lending all but non-existent. As a result, illegal money lending is not a rare phenomenon in Italy.

Meanwhile, Italy's consumer credit market remains underdeveloped, mainly as a result of formerly high interest rates and high saving rates. However, recent years

have seen significant growth – in particular with credit cards and point-of-sale finance – with many banks looking to take advantage of this unexploited market. Foreign lenders are now present, such as *Findomestic* (owned by *Cetelem*) and *Finagen* (owned by *Société Générale*), yet lending to sub-prime individuals remains uncommon, though at the near-prime level it is possible.

Sub-prime lending is made particularly difficult in Italy because the Government takes responsibility for setting a legal maximum interest rate, which is double the average rate charged. The Bank of Italy sets these maximums on a quarterly basis.

However, Italy's banking market remains fragmented and very regionalized, with few banks except the very large ones having national coverage. Because many Italians (particularly in rural areas) are still very dependent on their local branch for almost all of their financial needs – as well as many having a personal relationship with the branch manager – Datamonitor surmises that those customers with a low level of arrears who have a good personal relationship with their branch may be able to attain credit.

*The Netherlands has a number of active sub-prime lenders, but the market is still small*

There are a variety of small sub-prime lenders in the Dutch market, where mainstream lending is highly consolidated and the majority of banks do not lend to sub-prime individuals. In fact, while sub-prime lenders are active in this segment, there remains more room for other lenders as the market still has potential to expand. Indeed, the market remains subdued because of its negative reputation, as well as the fact that many in the lending industry and consumers remain unaware of the existence of these lenders. Yet while mortgage lending has grown well over the years, Dutch consumers continue to be averse to taking on unsecured debt. In addition, sub-prime lenders need to be aware of the interest rate ceiling.

Sub-prime lending in the Netherlands is discussed at greater length further on in this chapter.

*The sub-prime market in Norway is very limited*

The sub-prime lending market remains very small in Norway. Indeed, this situation was corroborated by branch managers surveyed, of whom over 80 per cent were not aware of any providers that offer sub-prime credit or said that there were no such

providers. Moreover, Norwegian banks remain conservative with regards to their lending criteria.

There are a number of providers such as GE Money Bank and Citibank which lend to some near-prime individuals, as well as other non-standard individuals. They are known to provide high interest rate loans to a variety of consumers. Yet they do not explicitly target sub-prime consumers. However, as in Sweden, the sub-prime population itself remains small as a result of a number of years of increasing property prices, low unemployment and a fairly strong economy, as well as a high rate of financial literacy.

#### *Portugal's sub-prime market has potential but remains small*

Portugal's sub-prime lending market is still undeveloped. There are now a number of lenders that specifically target sub-prime individuals for consolidation loans only, such as *e-loan* and *Banco Primus*. Meanwhile, newer consumer credit entrants such as GE Money and *Cofidis* tend to lend to the near-prime sector, but this depends very much on individual circumstances.

As such, there continues to be a gap that could be filled, as there has been an increase in the number of sub-prime individuals in recent years, due to a recession. Moreover, mainstream lenders stay out of this market and sub-prime lending does not suffer from a particularly tarnished reputation as in other countries.

The Portuguese sub-prime lending market is discussed in greater depth further on in this chapter.

#### *Spain's sub-prime lending market has much potential for growth*

The Spanish retail banking market has become increasingly competitive in recent years – with consolidation and a host of foreign entrants – encouraged by a strong economy and booming housing market. Most mainstream lenders continue to stay out of the sub-prime market, which makes for plenty of opportunity. This is more the case because there are currently few lenders serving the sub-prime market, although Datamonitor expects a significant number to enter over the next few years as increased competition leads to the development of niche lending segments. Moreover, sub-prime lending doesn't appear to suffer from a particularly poor reputation. Yet Spanish customers are highly dependent upon their branches, and independent distribution, though increasing, is still complex and not highly significant.

The opportunities of the Spanish sub-prime lending market are discussed in greater detail further on in this chapter.

*Sweden's mainstream lenders tend to cater for the near-prime, but the rest of sub-prime lending remains very small*

Sub-prime lending remains limited in Sweden. Moreover, its expansion continues to be undermined by the poor reputation it engenders. The Swedish banking market is highly consolidated, with the main four or five players controlling most of the lending market. These players tend to accept near-prime customers – particularly if they can show they have the means to repay their loan – although the degree to which they do does vary widely. There are currently two specialist non-standard and sub-prime players in the market, *Bluestep* and *Freedom Finance*, but both remain small. Indeed, there is doubt about the degree to which the sub-prime population will grow or become sizeable, given that the economy has performed well in recent years and there have been a low proportion of consumers with arrears, repossessions, or debt reconstructions.

*The UK has a significant sub-prime lending market*

As discussed in the previous chapter, the sub-prime lending market is highly developed in the UK. There are a great number of specialists in the market, offering mortgages, credit cards and personal loans. Moreover, many mainstream lenders are now active in the sector, often lending beyond the near-prime population, either in-house or via a subsidiary. What is more, sub-prime lending is no longer much associated with shame or poor lending practices, exhibiting the level of development the market has reached.

## **Mainstream banks continue to maintain conservative attitudes to lending**

As discussed, markets differ greatly with regards to the extent of sub-prime lending they undertake, often even at the near-prime level. One important reason for this can often be attributed to lender attitudes to sub-prime individuals. This section compares bank attitudes to lending criteria across Western European countries, taking an in-depth look at:

- changes in lending criteria over the last few years;

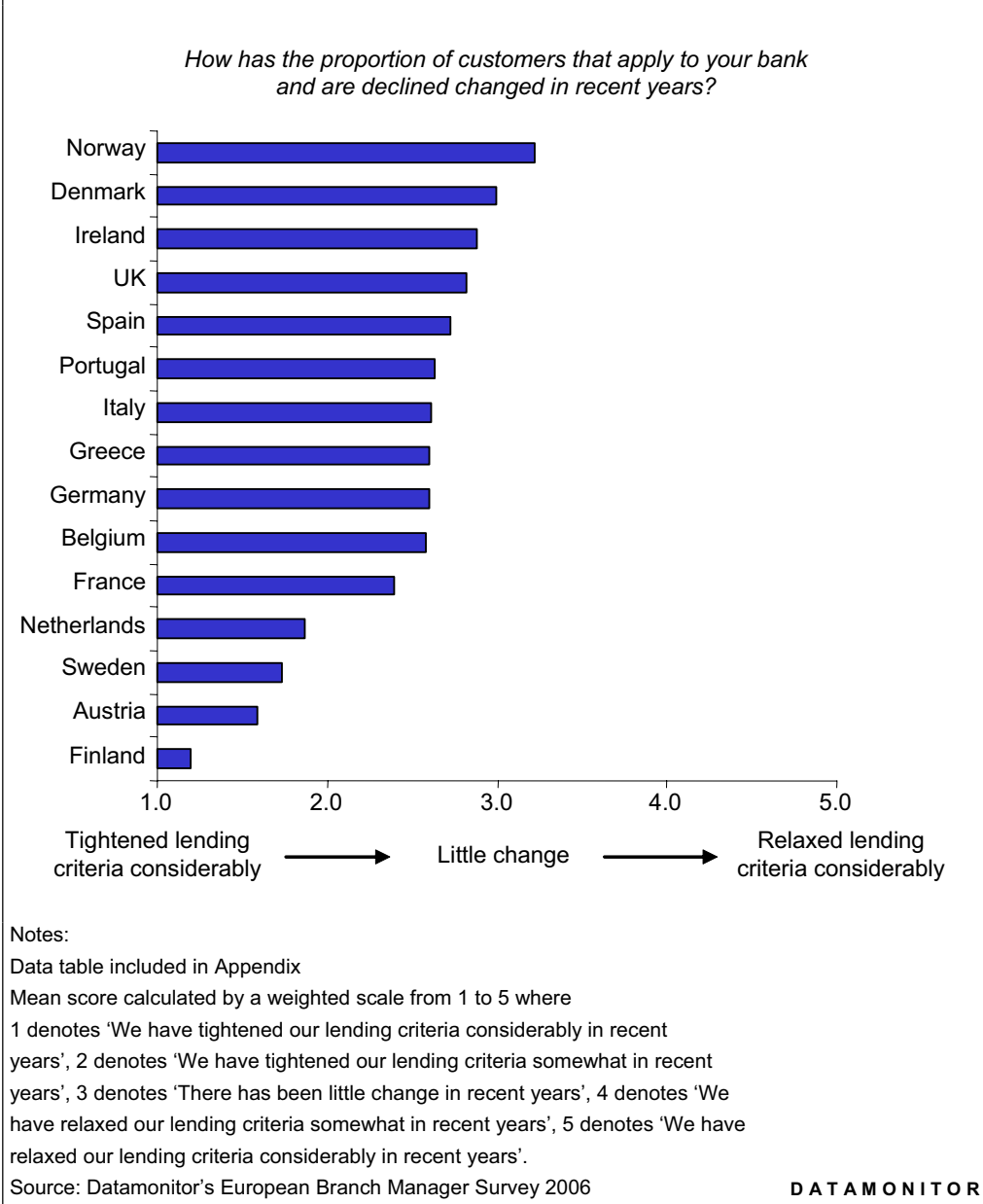
- lending to those with a minor history of credit arrears;
- lending to those with a major history of credit arrears;
- lending to those with a debt reconstruction on record.

### Most mainstream banks have tightened their lending criteria in recent years

Lending criteria changes over time. Indeed, a certain economic situation or a change in strategy can cause lenders to either tighten or relax their lending criteria. According to branch managers surveyed, most banks have been tightening their lending criteria in recent years. Such a sentiment is not surprising given that over the last decade European consumers have accrued a significant amount of debt. In addition, considering that many countries are not experiencing a fast expanding economy, it makes sense that banks would somewhat tighten their criteria in order not to get burned by bad debts.

The tightening of banks' lending criteria in recent years is demonstrated below.

**Figure 4: The majority of high street banks in Western Europe have tightened their lending criteria in recent years, 2006**

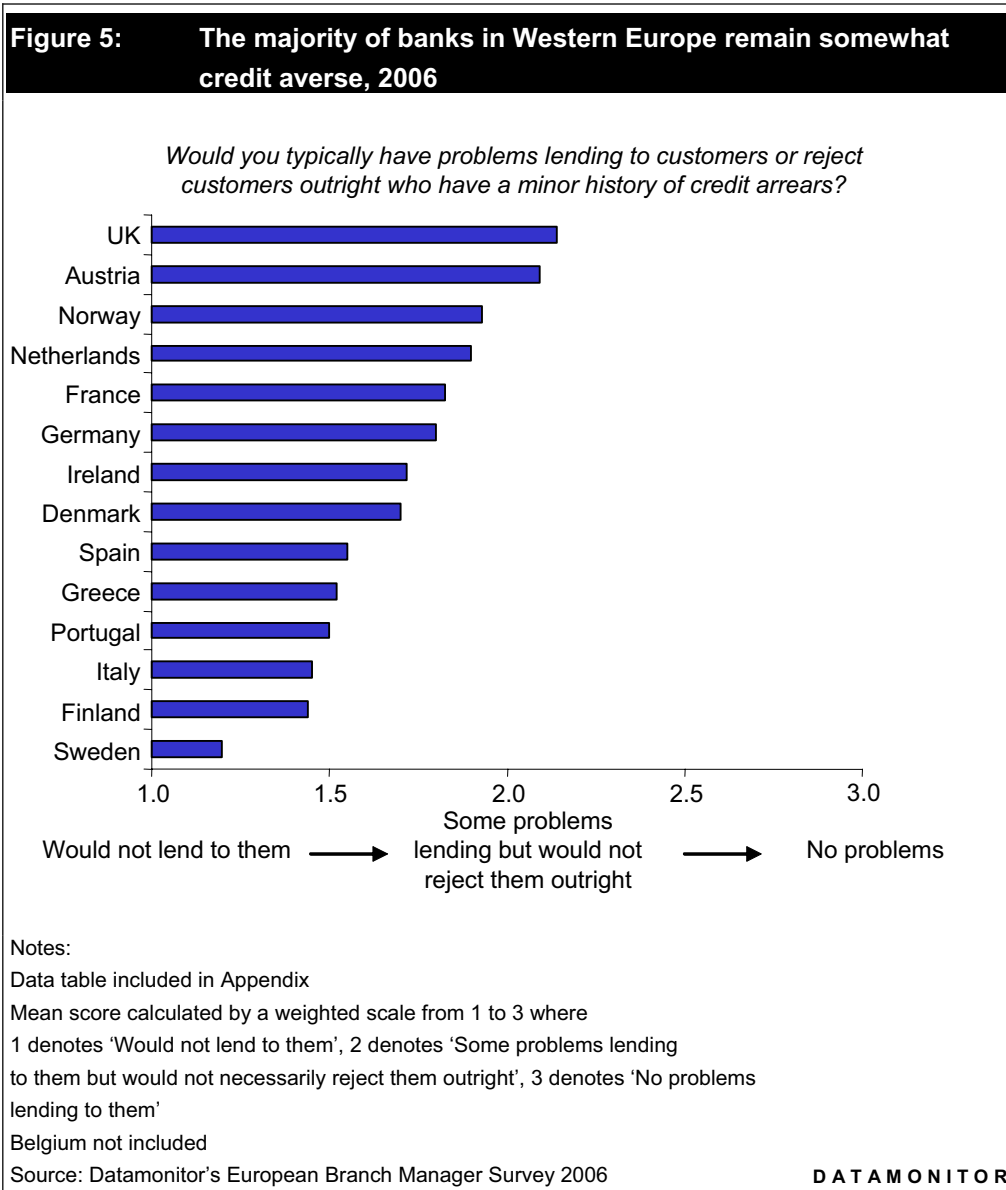


## The majority of mainstream banks remain somewhat risk averse to individuals with a minor history of credit arrears

Measuring the proportion of banks that lend to customers with minor credit problems is a good indication of the level of risk banks are comfortable with and, therefore, can correlate to their attitudes towards the near and heavy sub-prime sectors. As a market matures, lenders may look for niche segments – of which the near-prime is often the first or most suitable extension for banks to focus on.

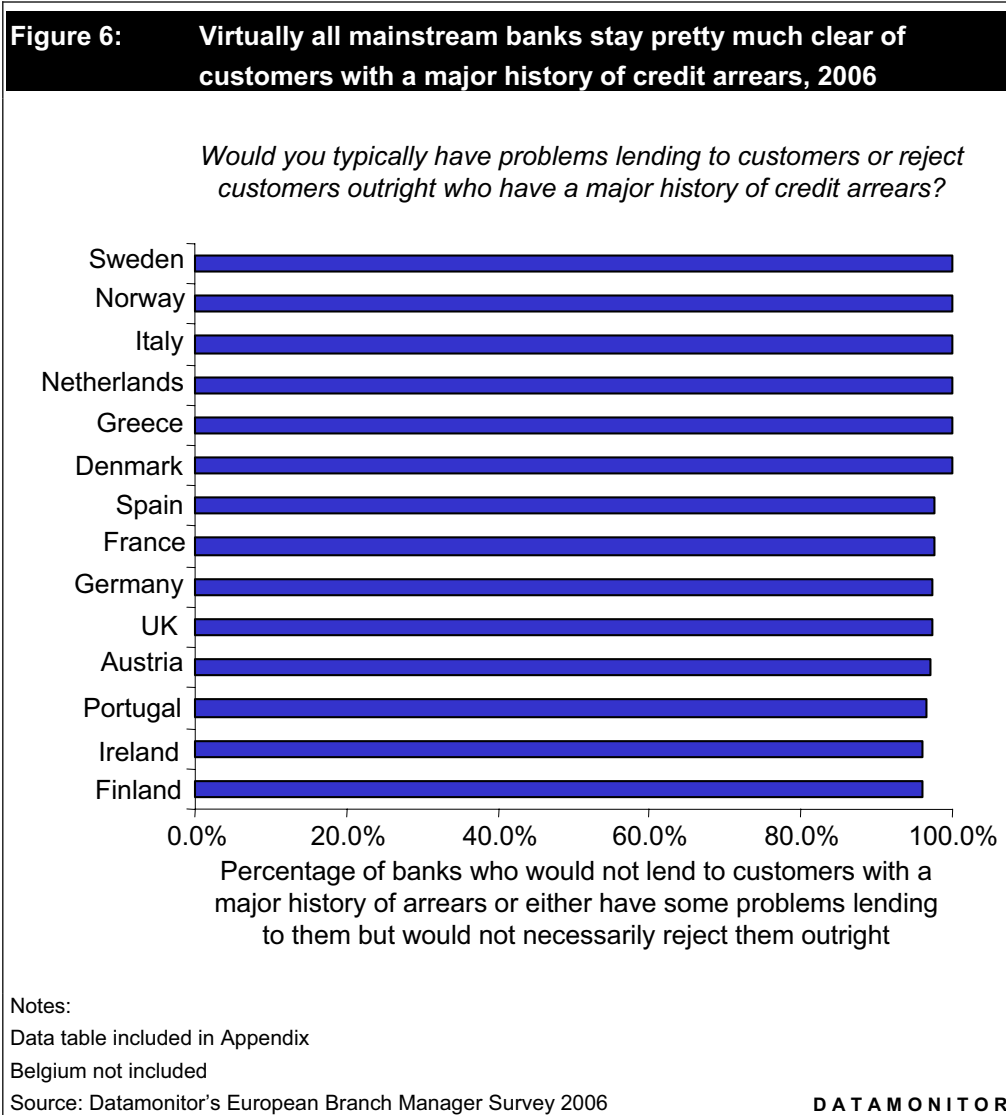
It is difficult for mainstream banks to enter the sub-prime market due to a lack of specific skills needed to participate successfully in this sector. If banks are interested in the sub-prime sector they will generally set up a bespoke in-house department that hires in the right skills. As a result, beginning by lending to the near-prime sector is a more natural progression for banks within a developed lending market.

The graphic below displays that a significant number of Western European banks remain risk averse, with the majority of banks either not lending to those with minor credit problems at all or else having some problems lending to such individuals but not rejecting them outright. Such a result is not surprising given the low level of development of sub-prime lending throughout most of Western Europe.



**Virtually all mainstream banks have problems accepting individuals with a major history of credit arrears**

Unsurprisingly, given that branch managers interviewed were already hesitant to accept customers with a minor history of credit arrears, virtually all banks are either not open to or have problems lending to individuals with a major history of credit arrears. This is displayed clearly in the graphic below.



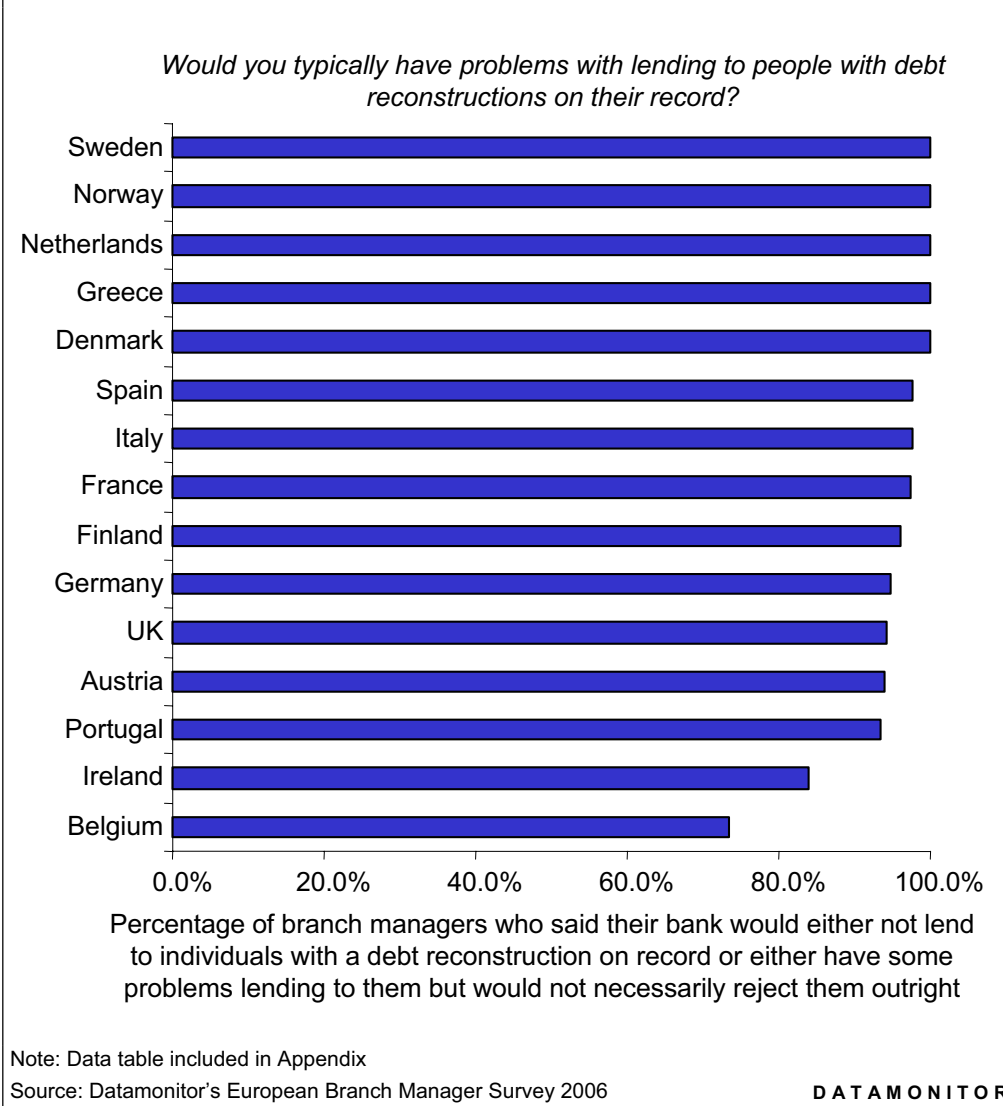
### Most mainstream banks do not tend to lend to those with a debt reconstruction on record

Given that a substantial number of banks remain credit averse, the majority of Western European banks are unlikely to lend to those individuals with a debt reconstruction on record. A debt reconstruction is when a heavily indebted consumer makes an agreement with his/her creditors that they are incapable of paying their debts within the foreseeable future. The essence of a debt reconstruction is that the

debtor is released from liability to pay the debts which are covered by the reconstruction to the extent that these have been reduced. In the end, the main purpose of the debt reconstruction system is to rehabilitate the finances of the person in debt.

Lending to such individuals necessitates undertaking a higher risk than usual as these customers have previously defaulted. As is shown in the graphic below, almost all branch managers surveyed said their bank would either not accept, or either have some problems, lending to such individuals.

**Figure 7: Banks in Western Europe almost always either reject or have some problems with lending to people with a debt reconstruction on their record, 2006**



Unsurprisingly, very few mainstream banks ordinarily accept applicants with a debt reconstruction. Instead, it is specialists, not high street banks, which would usually cater to those having a debt reconstruction on record if there were a developed sub-prime market.

## Yet sub-prime lending markets are changing across Western Europe

As discussed above, the majority of Western European mainstream lenders remain rather credit averse to individuals with even a minor history of credit arrears. Nevertheless, the sub-prime lending market is changing in many markets, as mainstream lenders and particularly specialist players wake up to the opportunity. The following section takes an in-depth view of a number of markets that Datamonitor believes have significant potential or are already showing this potential. Namely, Datamonitor believes that:

- **Ireland** is an example of a sub-prime lending market in fast transition;
- **Germany** is an interesting sub-prime lending market to consider for the future;
- **Spain** and the **Netherlands** hold significant sub-prime lending potential;
- **Portugal** and **Greece** have potential for expansion, but a number of factors hold them back.

Each market is discussed below in greater depth.

### Ireland is an example of a sub-prime lending market in fast transition

#### *The Irish lending market has become more competitive*

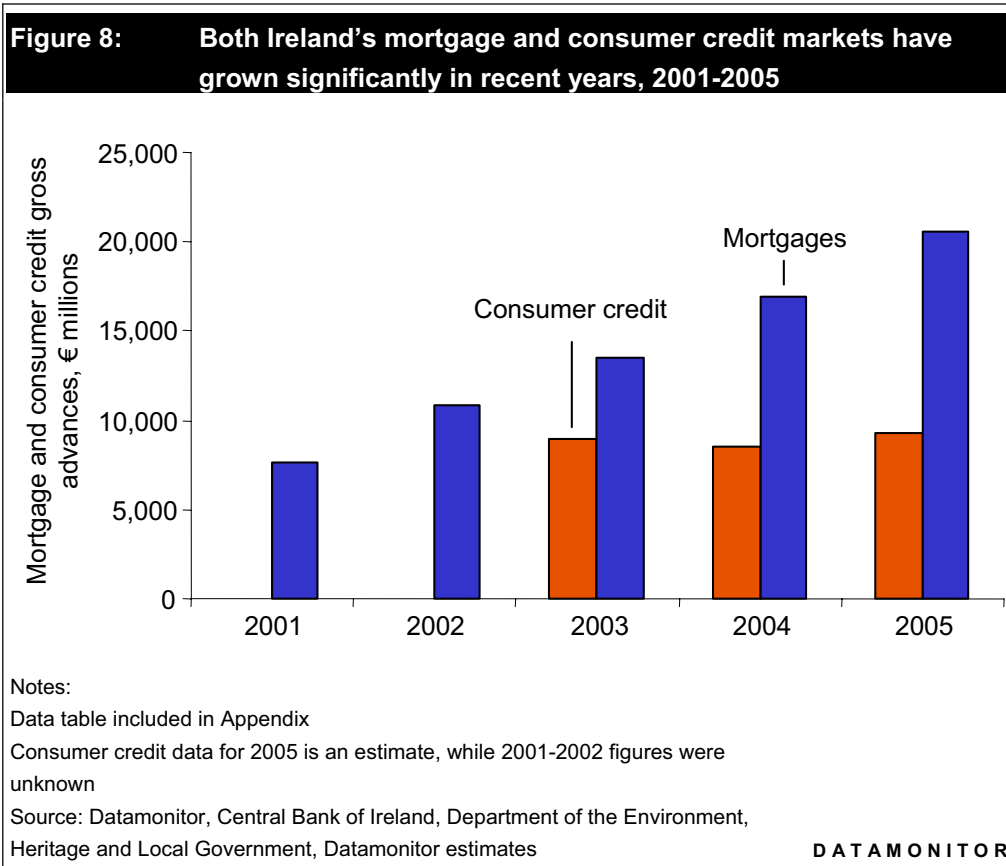
The Irish lending market has become increasingly competitive, with a significant number of Irish and foreign players now involved. In fact, the lending sector is viewed by many foreign players as a very attractive market, despite its small size. Indeed, a growing and healthy economy and the relative immaturity of the sector mean that profit margins and growth potential remain relatively high. Moreover, the Irish financial sector welcomes effective competition and, consequently, is very open to new and foreign players. In fact, a significant number of foreign financial institutions have entered the Irish banking market in recent years either by setting up a subsidiary or by acquisition. For example, MBNA and GE Money entered the market in 1997, followed by Tesco Personal Finance and *Rabobank* in 1999 and 2002 respectively. Yet it is important to mention that the Irish market remains far from saturated.

*The mortgage and consumer credit markets are booming*

With its entrance to the EU in 2002, the Irish economy has experienced robust growth, with exports being the primary growth engine. Yet increasing consumer spending, an expanding housing market and construction sector have also contributed to a healthy economy. Ireland continues to maintain low unemployment though inflation remains relatively high despite falling considerably in recent years.

Such an economic expansion has helped Ireland's mortgage and consumer credit markets to grow significantly in recent years. Together with Spain, the Netherlands, and the UK, Ireland has witnessed staggering increases in house prices fueled by falling interest rates, demographic pressures and housing demand outstripping supply. Such growth in house prices has helped the mortgage market escalate in terms of value. Meanwhile, the Irish have had an increasing appetite for debt in recent years. Consumer credit balances outstanding per capita in Ireland were €5,750 in 2005. This is the second highest level in Western Europe and there are concerns that Irish consumers are now becoming overindebted.

As is pictured below, both the Irish mortgage and consumer credit markets have grown. Fueled by factors such as rising house prices, strong consumer demand and lower cost of borrowing, gross advances in the Irish mortgage market grew at an estimated CAGR of 29.5 per cent from 2001 to 2005, to reach an estimated €21.5 billion in 2005. Meanwhile, estimated consumer credit gross advances in Ireland reached €9.3 billion in 2005 (gross lending figures prior to 2003 are not available). The rate of increase between 2004 and 2005 was 9.2 per cent – faster than many other Western European markets.



**Moreover, Datamonitor forecasts strong growth ahead**

Building on its good performance, Datamonitor believes that both the mortgage and consumer credit markets will see significant growth over the next few years, as Ireland's economy continues to benefit from healthy GDP growth, low unemployment and house price growth. However, increasing consumer indebtedness will slow growth down.

For further in-depth information on Ireland's mortgage and consumer credit markets, please refer to Datamonitor's *Mortgages in Ireland 2006* and *Consumer Credit in Ireland 2006* reports, as well as forthcoming updated versions *Mortgages in Ireland 2007* and *Consumer Credit in Ireland 2007*.

*Sub-prime lending is gaining momentum*

Sub-prime lending is expanding quickly in Ireland. Indeed, just as the UK market has followed the US, so Ireland is gradually following the UK. More interestingly though, because Ireland is culturally and linguistically closer to the UK than other markets, mainstream and sub-prime lenders who are active in the UK have also entered the Irish market, as well as non-UK entrants making their way in. As such, it can be argued that Ireland is the first non-UK European market in transition towards a more developed sub-prime market, and hence, presents opportunities for lenders. Shane O'Sullivan, chief executive of Springboard Mortgages, stated:

*"The specialist [of which sub-prime is an important element] market in Ireland is underdeveloped because so few companies have focused on it to date."*

**Specialists and mainstream lenders are entering the market**

A number of lenders are now active in the sub-prime lending market, with most offering mortgages at first. CitiFinancial, HFC Bank, Start Mortgages (a subsidiary of UK group Kensington), and GE Money are all specialists in the market. Investment banks are also entering the market, with the announcement of Nua Loans in January 2007 – a joint venture between South African bank Investec and Finance Ireland, also known as Fire. Interestingly – and in line with the development of the UK sub-prime lending market – a number of mainstream lenders have recently announced their intentions of entering the sub-prime market, namely IIB and Permanent TSB.

Irish Life & Permanent Plc (which owns Permanent TSB) and Merrill Lynch announced in early 2007 that they will form a joint venture for the origination of specialist residential mortgages. The specialist will be independently branded (so as not to associate the mainstream lender's brand with sub-prime) and regulated, called Springboard Mortgages. The new specialist lender will use Permanent TSB's leading experience in the mortgage market as well as its relationships with a wide range of intermediaries.

**Attitudes and awareness to sub-prime lending are changing**

Attitudes and awareness are slowly changing with regards to the sub-prime sector in Ireland. In Datamonitor's survey, over 70 per cent of branch managers – asked whether they were aware of any lenders that provide credit to people that would traditionally be refused credit from mainstream providers – were aware of and could

name at least one provider in this market. This is a high rate of awareness in comparison to many other countries surveyed by Datamonitor.

***Moreover, an increasing number of consumers are falling into the sub-prime category***

Another reason for the expansion of sub-prime lending is because it is reflective of Irish consumers. Irish consumers have become increasingly indebted over the last decade. Moreover, a mature (and expensive) housing market has meant that consumers are having to cope with unsecured debts as well as high monthly repayments. This has resulted in an increase in the actual number of sub-prime consumers.

As Christopher Taylor, CEO of London & European, wrote in the Mortgage Finance Gazette in October 2006,

*“... there are serious concerns in the Irish Government about the spiralling levels of personal debt and continuing increases in the cost of houses. The president of the European Central Bank has warned that eurozone interest rates are likely to rise further, which will put a further squeeze on consumers. Rising costs, falling competitiveness and an overdependence on certain sectors of the economy could lead to trouble for some ...”*

In fact, it is not only lower income individuals that are becoming a part of the sub-prime population. In July 2006, a survey carried out for GE Money by TNS/Omnibus revealed that around 34 per cent of high earners (those earning over €65,000) admitted that they had had serious money problems in the past year. GE Money said that sub-prime consumers represented only 2 per cent of its mortgage applications in 2003, compared to 15 per cent in 2006.

***But there are some reputation and regulatory concerns over sub-prime lending***

In December 2006, a Prime Time program on the television channel RTE entitled “Prime Time Investigates: ‘til debt do us part” was aired in Ireland that covered money lending and sub-prime lending. It uncovered a number of illegal practices and has since caused a commotion in the media that led to public discussion of implementing interest rate caps. It has also bruised the sub-prime lending industry’s reputation. CitiFinancial in particular was covered in depth, and according to the

investigation, is no longer looking for new lending, and is reassessing whether to remain in the Irish market.

Datamonitor does not suspect that interest rate caps will be set, as the lobby for this remains small. However, the Government may look to implement stricter regulatory criteria. If regulation gets tougher lenders need to make sure they can demonstrate that their charges and fees are fair and that interest rates are formed through risk-based pricing – otherwise they could get into legal trouble.

*GE Money is a leading player in the Irish sub-prime mortgage market*

GE Money provides specialized financing and services such as leasing, hire purchase, mortgages and loans to businesses and individuals across Ireland. GE Money, a unit of GE Consumer Finance, has US\$150 billion (€116 billion) in assets, and is a leading provider of credit services to consumers, retailers and auto dealers in 47 countries around the world.


GE Money has had a presence in the Irish consumer credit market since 1997, when it acquired Woodchester Investments plc. As part of a global rebranding, in 2005 the company rebranded from GE Capital Woodchester to GE Money.

***GE Money openly targets sub-prime and self-employed individuals***

GE Money is one of the main sub-prime mortgage players in Ireland at present. It targets its mortgages at people who do not meet 'normal lending criteria' and those who have been declined by other lenders. These include self-employed consumers (without a long enough record of proof of income), those without a long enough credit history, as well as those who have been in arrears, carry CCJs, written off debts and have revoked credit cards. This targeting can be seen from its website below.

**Figure 9: GE Money clearly targets the sub-prime population – among others – for its mortgages, February 2007**

Mortgages



**At GE Money we look to the future**

Have you been refused a mortgage? Maybe you've had payment arrears, have an irregular income or difficulty proving your income?

The GE Money Mortgage might be the solution for you. At GE Money we look at your current ability to repay, not just your credit history.

With the GE Money Mortgage you could release some of the value tied up in your home, roll all your debts into one monthly repayment or finance a new home.

Source: Datamonitor, GE Money Ireland ([www.gemoney.ie](http://www.gemoney.ie)) **DATAMONITOR**

***GE Money offers four types of mortgage***

GE Money offers four different mortgages, one for first time buyers (FTBs), one for the self-employed, a refinancing and a top-up option. Customers can borrow from €30,000 for a term of 10 through 35 years.

GE Money distributes its mortgages mainly through an intermediary network as well as through its own centers.

*The Irish sub-prime market is likely to see significant growth given that the factors which could inhibit growth in this market are limited*

The Irish lending market is far from being saturated and offers significant opportunities in the sub-prime sector, where there remains a large illegal lending market. Lenders have been entering the market and Datamonitor expects more to enter over the next few years. Indeed, the Irish sub-prime market is at a stage of transformation, in that in a few years, it will look closer in maturity and competitiveness to that of the UK. Lenders establishing themselves in the market sooner will have the greater advantage. This is even more so considering that factors which could inhibit growth are in lenders' favor:

- **distribution** – brokers are significantly important to mortgage distribution in Ireland. Estimates vary, but it is thought that roughly 40 to 50 per cent of new business is being generated via the broker channel, which includes both independent and tied agents. Such a situation makes it easier for new entrants to get into the market and gain market share without the need to set up a brand or physical outlet;
- **credit bureaux** – lenders have access to a wide range of data from the biggest credit reference agency in Ireland, the Irish Credit Bureau (ICB), set up in 1965 by a group of financial institutions. Credit products monitored include mortgages, personal loans, credit cards, leasing, hire purchase and car loans. Overdraft agreements, which are not the subject of legal proceedings, are not covered. Access to this information is reserved to ICB's members. The borrower's payment profile history is normally recorded over a two-year repayment period and information is for a period of five years. Experian also provides credit bureaux services in Ireland;
- **repossession and the rule of law** – lenders are able to repossess a property relatively quickly and cheaply in Ireland;
- **competition** – at present there remains a large segment of illegal money lenders in Ireland targeting lower income families. This poses as an opportunity for sub-prime lenders.

### Germany is an interesting sub-prime lending market to consider for the future

Perhaps not an obvious choice, Germany – due to the size of its population and its current lack of sub-prime facilities – makes for an interesting market to consider. For many years foreign banks had been put off from entering the German market, given some of the structural and competitive challenges it posed, as well as consumers (spending-wise) who were not as attractive as other markets. However, the tide seems to be changing and there are a number of foreign banks in the market, including *ABN AMRO*, Citibank, GMAC-RFC, Royal Bank of Scotland, and GE Money Bank, among others. Indeed, there remains room for lenders with innovative products to enter the market, in particular the sub-prime market. Moreover, years of economic problems have meant the emergence of a significant sub-prime population.

*Germany's mortgage and consumer credit markets will improve over the next five years*

Germany's mortgage market has not performed particularly well over the last five years, mainly due to a sluggish economy and also in part to an oversupply of housing. The same can be said of the consumer credit market, where a traditional savings culture, banks' focus on other products, consumer protectionism and weak economic performance have all restricted growth. However, the economy picked up during the summer of 2006 and looks to be building a mild recovery.

In fact, Datamonitor forecasts both markets to improve gradually over the next five years. The economy is expected to improve and house prices are expected to rise, which will support growth. Moreover, in the context of mortgage lending, homeownership remains low, meaning that there is significant scope for expansion, and the importance of intermediaries is likely to increase significantly.

*For further in-depth information on Germany's mortgage and consumer credit markets, please refer to Datamonitor's Mortgages in Germany 2006 and Consumer Credit in Germany 2006 and forthcoming updates Mortgages in Germany 2007 and Consumer Credit in Germany 2007.*

*Sub-prime lending remains very small up to now*

Sub-prime lending in Germany remains very limited up to now, with a very small number of lenders partaking in the market. Indeed, as was shown in the section above, the great majority of banks do not accept customers with a less than good credit score. In the words of one industry executive,

*"Banks do not give loans to these types of people. Sub-prime consumers are not served at all."*

Moreover, it is not a market that gets any significant focus, nor much press attention. In the words of one industry insider,

*"Sub-prime lending is just not a topic on the agenda; there is no lobby for this. In general it gets left out of the conversation."*

***Attitudes hold back this type of lending***

Banks maintain a conservative lending attitude in Germany, which has restricted the development of sub-prime lending. One insider commented,

*“Germany is very conservative in its lending. None of the traditional banks offer sub-prime lending. Some other smaller lenders outside the mainstream may do near-prime lending, but we ourselves hardly ever do that.”*

In fact, risk-based pricing is still not pervasive in Germany, with estimates of around 50 per cent of lenders using this model. A lender not using this model will therefore be automatically excluded from sub-prime lending.

Moreover, Datamonitor’s survey uncovered a wide lack of awareness of the presence of lending to consumers that are traditionally refused credit from mainstream providers. In fact, the majority of branch managers surveyed in Germany were not aware of any lenders that offer credit to such people. Others who did say they were aware of such lenders could not often identify the correct players. Such a lack of awareness underlines the significant lack of development of this sector, as well as underlining the tremendous opportunities to those lenders who do invest in it. In some cases respondents said that “it was a private matter” and would not say who the particular lenders active in the market were, indicating the somewhat hush-hush attitude this type of lending still engenders in Germany.

***Moreover, there is an interest rate cap, though it is reasonably high***

Detracting from some of its lustre in the eyes of lenders, Germany is among a number of European countries that set an interest rate ceiling on lending. At present the maximum rate is “double the market average” rate of lending. However, there is a certain amount of debate around the method of calculation for this cap – and according to lenders Datamonitor spoke with for the purpose of this report – the actual interest rate ceiling is not fully defined in terms of which particular loans are included in the calculation. In the summer of 2006, the ceiling for unsecured personal loans was around 14 per cent, but it has now been loosened to around 16 to 17 per cent. The *Bundesbank* publishes market averages for different forms of credit each month.

Because of this cap, Datamonitor believes that it is sub-prime mortgage lending – rather than personal lending – that offers current and prospective lenders the most

opportunity in Germany, as secured lending interest rates are almost always lower and therefore more likely to fall under the ceiling.

Moreover, there are other laws in regards to consumer credit that have had an effect on both the supply and demand in the market. For instance, German law forbids free balance transfers or interest rate teasers on cards, and it was only in 2001 that restrictions on co-branded and affinity cards were relaxed.

*But the market holds considerable potential, and there are a few lenders in the sub-prime business*

While the presence of an interest rate ceiling does make it somewhat more difficult for lenders targeting sub-prime customers, it does not make it impossible. In fact, there are already lenders active in the sub-prime market, with the bigger ones tending more to near-prime.

Indeed, it is likely that GMAC-RFC, Citibank, GE Money Bank each does a small amount of near-prime lending, along with high LTV (loan-to-value) and other specialist lending to other customers that are not accepted by mainstream lenders. Then there are a small number of German lenders, who according to some, do not afford the best of reputations because of the tainted reputation that sub-prime lending carries. These include *Bon-Kredit*, *Creditolo*, and *Kredit1a*, all of whom do not use *Schufa* (the main credit bureau) as a credit scoring device.

In fact, the potential for sub-prime lending, in particular for mortgages, is substantial. Indeed, given that the great majority of high street banks continue to remain well-away from sub-prime lending, a lender going into this sector would benefit from reduced competition. It is likely that as foreign lenders begin seeing the sizeable opportunities in Germany, so in the long-term German competitors may also become more open to this type of lending, though it will necessitate a change in cultural attitude. One industry executive commented,

*"I see German banks in the long-run starting to lend to sub-prime customers, but in the short-term it will be powered by foreign entrants."*

***Moreover, other characteristics are also positive for its future development***

In addition, a number of characteristics of the German lending market would be conducive to sub-prime lending:

- **distribution** – while bank branches currently dominate the distribution of mortgages and consumer credit, intermediaries are becoming increasingly important;
- **credit bureaux** – *Schufa* is Germany's main credit reference agency. Many lenders do not use additional consumer data information providers, as the information *Schufa* provides is comprehensive enough;
- **repossession and the rule of law** – repossession in Germany is relatively efficient, taking approximately twelve months.

## Spain and the Netherlands hold significant sub-prime lending potential

Both Spain and the Netherlands pose significant potential for the further development of sub-prime lending. Each is discussed below.

### *The Spanish sub-prime lending market is likely to grow significantly in the future*

Encouraged by a robust economy and fast rising house prices, the Spanish mortgage and consumer credit markets have expanded significantly over the last decade. Moreover, they are likely to continue to expand, though not as rapidly. Spain has seen a host of foreign entrants and consolidation in the market over the last few years, in what has become a highly competitive lending market.

For further in-depth information on Spain's mortgage and consumer credit markets, please refer to Datamonitor's *Mortgages in Spain 2006* and *Consumer Credit in Spain 2006* reports and forthcoming updates *Mortgages in Spain 2007* and *Consumer Credit in Spain 2007*.

### ***Most mainstream lenders remain out of the sub-prime market***

The majority of mainstream Spanish banks do not lend to sub-prime customers. However, customers with a minor history of credit arrears will usually be able to find at least one mainstream lender to accept them. Moreover, it can often depend upon the customer's previous relationship with the lender. As such, mainstream lenders remain far out of the medium or heavy sub-prime market. Moreover, mainstream

lenders are not yet very interested in serving these customers, with this sector not being on the agenda for the time being.

***But there are a few lenders already serving the sub-prime market***

While the sub-prime lending market is not nearly as developed as in the UK and Ireland, there do exist a number of Spanish and foreign lenders in this segment, including *Losada*, *Cofidis*, *Credifacil*, GE Money Bank, *Unión de Créditos Inmobiliarios*, and GMAC-RFC. Yet sub-prime lending is still very much at the beginning stages here, and many of these lenders cater primarily to prime individuals as well as the self-employed and contract workers.

***Datamonitor believes this market has significant potential***

Datamonitor believes that the Spanish market has significant potential for both sub-prime mortgage and personal lending. Indeed, there already is a sizeable sub-prime population. Moreover, considering the increased number of people with both high mortgage and unsecured repayments (combined with an interest rate that is currently rising); it is likely that the sub-prime population will increase over the next few years. In addition, Datamonitor believes that while growth of both the Spanish mortgage and consumer credit markets will be less than the previous five years, growth will still be strong, indicating both markets are not yet fully mature.

What is more, the Spanish retail lending market exhibits a number of positive characteristics that suit current and prospective sub-prime lenders:

- **credit bureaux** – the Spanish credit reference system holds a considerable amount of consumer information on record. Data on current credit status (loans, debts, number of loans, the total amount of outstanding debt), and a detailed explanation of all arrears that have not been paid (which kind, which institution lent the credit, mortgage repossessions) is available. However, by law any data must be immediately erased from any credit register when a debt is paid. Moreover, Equifax and Experian are both present in the market;
- **repossession and the rule of law** – repossession legislation in Spain is lender friendly – the majority taking a duration of around ten months. However, the majority of those in repayment difficulties will settle a new method of repayment with the bank before court procedures become

necessary. Moreover, usury rate maximums do not exist in Spain. Rather, the lender makes a decision on what interest rate to charge;

- **attitudes to lending** – lending to sub-prime individuals is not associated with the same type of negative attitude or reputation that it meets in other countries, such as Germany or Denmark. While many lenders and consumers are not particularly aware of this type of lending, it does not suffer as much from a poor reputation, and as such, lenders risk less of damaging their reputation by being active in this market.

However, distribution is more complex in Spain, and may prove a difficult obstacle for lenders dependent upon intermediaries. Spanish consumers are heavily dependent upon bank branches, with Spain having one of the highest rates of branches per capita in Europe. Nevertheless, lenders without branches are seeing success, using television, and the Internet to their advantage. In fact, independent distribution can be hard to find in Spain. Nevertheless, according to interviews, this sector is growing and could potentially be a channel of growth in the future.

*The Netherlands is also likely to be a growth market for sub-prime lending*

With rising unemployment, low consumer confidence, poor economic performance and a culture that is averse to debt, the Dutch consumer credit has performed poorly in recent years. Credit cards in particular have remained with low penetration rates. Yet in contrast, the mortgage market has grown strongly, supported by strong house price growth, though the market has reached a high level of maturity.

Datamonitor believes that there is significant potential for the further development of the Dutch sub-prime market, particularly in the mortgage market. While Datamonitor does not predict strong growth for the Dutch consumer credit market (as well as subdued growth in the mortgage market) there nevertheless remains space for unsecured sub-prime lending, particularly because it remains undeveloped. However, Datamonitor believes that lending in this segment would prove tougher than in the secured segment.

For further in-depth information on the Netherlands' mortgage and consumer credit markets, please refer to Datamonitor's *Mortgages in the Benelux 2006* and *Consumer Credit in the Benelux 2006* reports and forthcoming *Mortgages in the Netherlands 2007* and *Consumer Credit in the Netherlands 2007*.

***The vast majority of mainstream lenders stay out of the sub-prime market***

Dutch mainstream banks apply very strict lending criteria with regards to credit arrears. Even those individuals with a minor record of arrears will have limited access to mainstream lenders. In fact, the majority of branch managers that Datamonitor interviewed said that their bank had tightened lending criteria in recent years. A number of reasons can account for this, including uncertainty in the housing market, high household debt and a weak economic outlook. As a result, there is plenty of opportunity for lenders wishing to offer credit to sub-prime customers.

***There are already a number of lenders present in the Dutch sub-prime market***

The sub-prime lending market is not wholly undeveloped in the Netherlands. In fact, there are a range of lenders active in the market, with unsecured providers such as *DSB, Stadsbank, Krediet Bank* and *Poskrediet*, as well as mortgage providers such as *GMAC-RFC, Sparck Hypotheken*. Nevertheless, there remains a sizeable opportunity in the market for other lenders as well. Indeed, there is a clear demand for such products and the market is likely to grow as mainstream lenders are likely to remain uninterested in lending to such individuals in the short-term.

***Credit bureaux, repossessions and distribution are all clearly defined and are positive characteristics for sub-prime lenders in the market***

Sub-prime lenders in the Dutch market can benefit from a number of positives, including:

- **credit bureaux** – the Dutch credit reference system holds a considerable amount of consumer information on record. The registry emphasizes positive data, including the nature of lending or other transactions and the start and end dates. Data on mortgage borrowing is currently restricted to installments due for more than 120 days, but data regarding unpaid debts is retained for an unlimited period; data on debts that have been settled is retained for five years to facilitate identification of individuals who systematically delay payment;
- **repossession and the rule of law** – there is strong legal protection for lenders in case of borrowers defaulting. Under the Civil Code and Code of Civil Procedure, mortgage lenders are allowed to apply for an attachment to the borrower's income during the foreclosure process. This, in turn, allows lenders to have recourse to legal action for a proportion of the mortgage

holder's income. Moreover, if the lender experiences a loss after the foreclosure process, it can go to court and have the assets of the borrower seized in order to recoup the loss. Repossession procedures generally take less than nine months;

- **distribution** – intermediary distribution is highly important in the Dutch mortgage market, accounting for around 50 to 60 per cent of all mortgage originations. For unsecured lending products, bank branches and the Internet are both important origination channels.

***Yet there are a number of negative factors sub-prime lenders have to negotiate themselves around***

There still remain a number of drawbacks to the Dutch lending market that lenders operating in the sub-prime market have to negotiate around. These include:

- **attitudes to lending** – lending to sub-prime individuals remains associated with a negative attitude or reputation. In fact, a small number of unsecured sub-prime lenders have received public criticism over the last years, in reference to misleading advertising and the setting of interest rates. As such lenders must be careful in the way they present themselves in order to reduce the risk of negative PR. However, firms that operate transparently and honestly should not face a PR problem;
- **interest rate cap** – because of the presence of a cap rate, there is a limit on the rates that sub-prime lenders can charge. However, it is not as low as that of other countries such as France, and as a result, lenders are still able to charge high enough rates to compensate for the risk they are undertaking;
- **consumer attitudes to debt** – on the secured side, consumers are not averse to taking on debt. However, on the unsecured side, Dutch consumers on the whole remain averse to debt. Nevertheless, attitudes are changing gradually, and particularly for those customers who are trying to gain access to unsecured credit, there is sufficient demand for lenders to be in the market.

Portugal and Greece have potential for expansion, but a number of factors hold them back

*Portugal's sub-prime market is still small but poses good opportunities*

Portugal's mortgage and consumer credit markets have seen a mixed performance in recent years. While mortgage balances have grown steadily in recent years, gross advances have seen a mixed performance as a result of the Portuguese recession. Yet gross advances look to be back on track and are growing again. Meanwhile, the consumer credit market has grown strongly in recent years except during 2002-3 as a result of the recession. Indeed, while the Portuguese savings rate is still higher than other countries in the Euro zone, attitudes towards debt have changed quickly in recent years and Portuguese consumers are increasingly open to taking out unsecured credit. Datamonitor expects the Portuguese mortgage and consumer credit markets to grow steadily in the next few years.

Banks remain the leading providers of mortgages and consumer credit in Portugal, but recent years have seen the entrance of other players, including distance players (by telephone and Internet) and finance houses, including *Cofidis*, *Banco Primus*, *Médiatis*, *Cetelem* and *Crediplus*. These players are using more innovative and proactive methods of customer acquisition, such as television exposure and developing relationships via remote channels of distribution. Indeed, new entrants have been able to carve out successful niches, and there is room for more providers to become involved. Many were lured into the Portuguese market by its relatively undeveloped nature and significant potential for growth. Barclays has had a presence in the country since 1985 and BBVA set up operations in 1991.

For further in-depth information on Portugal's mortgage and consumer credit markets, please refer to Datamonitor's *Mortgages in Portugal 2006* and *Consumer Credit in Portugal 2006* reports and forthcoming updated versions *Mortgages in Portugal 2007* and *Consumer Credit in Portugal 2007*.

***Portugal's sub-prime lending market is still small***

Portugal's sub-prime lending market remains undeveloped. At the moment, the market seems to be at a point whereby lenders offering credit to sub-prime individuals tend to offer only consolidation loans secured on property. Such a situation shows that there is ample room for further development in the market. Such lenders include *e-loan* and *Banco Primus*, profiled below.

In fact, the great majority of Portuguese branch managers surveyed did not know of the existence of any lenders that operated in the sub-prime market. Those that did know noted distance providers such as *Médiatis*, *Cofidis*, *Credibom*, *Banco Primus*, GE Money and Citibank. However, the majority of these players are involved in consumer credit only, and therefore are most likely only to be lending to the near-prime sector.

***As an example, Banco Primus is one of the leaders in the sub-prime consolidated loans market***

Active in the market since August 2005, *Banco Primus* is 65 per cent owned by a group of 30 individual Portuguese investors and 35 per cent owned by *Crédit Foncier*, part of the *Groupe Caisse d'Épargne* in France.

It operates on a distance basis, in that clients contact the lender by telephone or by post, in order to start the application process (which is done mainly via post). Loans are for a minimum of 3 years, with a maximum length of 57 years, as long as the customer is under 75 years of age.

*Banco Primus* is an innovator in the market in that it explicitly goes after the sub-prime population, which most others in the market do not yet do. As is shown in the graphic below, *Banco Primus* explicitly caters to those whose payments have been or are in arrears.

**Figure 10: Banco Primus targets sub-prime and mainstream customers for consolidation loans, February 2007**



**Banco PRIMUS**

QUEM SOMOS | PRODUTOS | EXEMPLO

Veja como é fácil:

 +  +  = 1050€ / mês

Com o **consolide** : **525€ / mês**

Exemplo >

**SOLUÇÃO PARA REDUZIR PRESTAÇÕES MENSAIS ATÉ 50%**

**SOLUÇÃO PARA CRÉDITO ADICIONAL**

**SOLUÇÃO PARA CLIENTES COM PRESTAÇÕES EM ATRASO**

A solution to reduce your monthly payments by up to 50%

A solution for additional credit

A solution for customers with payments in arrears

Source: Datamonitor, Banco Primus ([www.bancoprimus.pt](http://www.bancoprimus.pt)) DATAMONITOR

***A number of other factors make Portugal attractive for sub-prime lending***

In addition to an as of yet mostly undeveloped sub-prime lending market, the Portuguese market also offers other advantages to current and prospective lenders, including:

- **population of the sub-prime population** – there has been an increase in the sub-prime population in the last few years as a result of the recession. Portuguese consumers have increasingly become culturally more open to

debt, but the recession in 2002 and 2003, as well as a weak economy since then has meant that the sub-prime population has become sizeable. Indeed, the *Caixa Geral de Depósitos* (one of Portugal's largest banks) estimated that 2002 and 2003 had a significant effect on the number of people with payment arrears;

- **the economic situation** – the Portuguese economy remains with some core weaknesses, namely unemployment and a weak manufacturing sector in comparison to other export markets. Moreover, the economy has still not fully recovered since the 2002-3 recession. While such circumstances may put somewhat of a damper on the demand for credit (particularly unsecured credit), for sub-prime lenders it is not particularly negative as a weak economic environment is likely to produce a greater pool of sub-prime consumers, given the high level of secured and unsecured indebtedness of Portuguese consumers;
- **level of competition** – mainstream lenders do not tend to accept sub-prime consumers. While some near-prime customers with a strong relationship with their lender may be able to obtain credit, most are unable to do so;
- **attitudes to lending** – sub-prime lending in Portugal does not suffer from the same negative or 'dodgy' connotation it carries in a number of other countries mentioned. While mainstream lenders do not partake in this type of lending, so far sub-prime lenders have not been on the receiving end of negative PR or government regulation.

***Yet there are a few obstacles sub-prime lenders may come up against***

Though the Portuguese market offers excellent prospects for sub-prime lenders, there are a few factors that lenders must take into consideration:

- **distribution** – as the Portuguese mortgage market is controlled by its major banks, the large majority of mortgages are sold in branches, with a limited amount sold through intermediaries. This may make it somewhat more difficult for sub-prime lenders to acquire customers. However, on the unsecured side, there are a great number of consumer credit providers operating by distance channels. Moreover, GE Money also operates mainly via intermediaries and distance channels (in addition to its four offices in Portugal);

- **credit bureaux** – access to consumers' data information is, on the whole, good in Portugal. The dominant credit bureau is a joint venture between *Equifax* and *ASFAC*. But the National Banking Secrecy Act prohibits the sharing of data by financial and non-financial enterprises and the registry – which features positive and negative data – currently does not receive information direct from retailers or utility providers. Yet there are also other private credit information companies, including *Coface MOPE* and *Informa D&B*;
- **repossession and the rule of law** – mortgage repossessions tend to be lengthier than in many other Western European countries. They take approximately 20 months or less, as Portuguese legal processes are complex and legislation tends to be borrower-friendly;
- **size of the market** – while Portugal may be a highly attractive market for sub-prime lenders, with a population of 10.6 million (as per the CIA World Factbook), the actual number of potential sub-prime customers is significantly lower than in larger European countries. Each lender, whether already operating in Portugal or considering entry into a new market, will need to assess its viability as a result.

*The Greek sub-prime sector remains an untapped opportunity, but development may be difficult*

Off the back of a healthy economy – driven by an expansion in investment and infrastructure renovation due to the Athens Olympic Games in 2004 – both the Greek mortgage and consumer credit markets have grown substantially. Moreover, the Greek banking sector has attracted foreign competitors, many who have established strategic alliances with Greek banks. Indeed, Datamonitor expects both the mortgage and consumer credit markets to continue solid expansion with the help of a continuing well-performing economy, increasing competition from players and a rising housing market.

***Mainstream lenders stay out of anything besides near-prime lending***

Greek mainstream banks, such as the *National Bank of Greece*, *EGF Eurobank*, and *Alpha Bank*, have started to offer an array of more innovative products in the last few years. Yet they continue to maintain conservative lending criteria – and as such – stay well clear of anything except near-prime lending. Indeed, this is not surprising

given that many banks in Greece do not use risk-based pricing. In the words of one industry expert,

*“Risk-based pricing is not so widespread in Greece as in other European markets.”*

***Sub-prime lending is very much at the beginning stage***

Sub-prime lending is just at the beginning of its development in Greece. When the Bank of Greece revoked maximum limits on consumer credit in 2004, Greek banks and new entrants started to offer a wider variety of consumer and personal loans to private individuals. The change in regulation led to more innovation in what has become a competitive market.

Providers such as *Cetelem* and *Cofidis* have brought in sophisticated specialist credit scoring systems, as well as effective debt collection departments. In fact, finance houses have become aggressive in seeking customers through telemarketing and other methods. Other foreign lenders such as Citibank have also come in, offering debt consolidation loans. In addition, telephone and Internet-based banks such as *Easy Loan* and *SmartBank* have appeared. Yet such providers target mainly the mainstream population, though they may do a small proportion of lending to near-prime individuals, as do mainstream lenders.

As such, a sizeable gap exists in the market, whereby those consumers that are unable to gain access to such providers are forced to resort to an already significant illegal money market in Greece.

What is more, awareness of a sub-prime presence is still very low, even with employees within the retail banking sector itself. Indeed, over a third of branch managers surveyed by Datamonitor were unaware of any lenders offering sub-prime credit in Greece. In the words of two interviewees Datamonitor spoke with,

*“Such a trend is starting to appear in the market but the presence of such organizations that offer these products is still weak.”*

*“There is no particular organization – big or small – that is known for accepting sub-prime consumers. Moreover, there is no organization that advertises to these particular individuals.”*

***But developing the sub-prime market may be difficult***

While Greece could be a very attractive market for sub-prime lenders to launch into, a number of factors may cause difficulty:

- **attitudes towards lending** – those few existing lenders catering to the sub-prime population have suffered because of the negative connotation such lending carries. Though this is likely to change as sub-prime lending expands, it will still impact upon lenders in the short-term;
- **distribution** – the branch remains the chief distribution channel in Greece. Though some lenders have started establishing partnership agreements with third-parties in the real estate sector for mortgage distribution, they remain of paramount importance. However, for consumer credit in particular, the Internet and telephone as sales channels are gradually becoming important with the entrance of remote players such as *Cetelem*;
- **credit bureaux** – the credit rating system in Greece is underdeveloped. The sole centralized credit bureau in Greece is *Tiresias*, which is a public limited company created on the initiative of the *Hellenic Bank Association (HBA)*. Although the credit databank was established in 2001, it only started collecting credit histories of loan and mortgage consumers in 2003. According to the European Central Bank (ECB), the registry includes records of persons who have drawn uncovered checks and bills of exchange, unilaterally terminated contracts involving loans and credit cards, unfavorable court rulings regarding for example, confiscation and mortgages. Yet the Bank of Greece is trying to address the credit rating system's limitations;
- **size of the market** – Greece may be a highly attractive market for sub-prime lenders, but with its population of 10.7 million (as per the CIA World Factbook), the actual number of potential sub-prime customers is significantly lower than in larger European countries. Lenders operating here or those considering entry will have to take this aspect into consideration.

## CHAPTER 4 CONCLUSIONS

### **Sub-prime lending will become more common as time goes on**

As retail banking markets develop across Europe in terms of complexity and competition, so will sub-prime lending. Indeed, as the mainstream lending sector continues to experience diminishing margins, lenders will look to other segments to increase their profits and increase their pool of customers. One of these segments is surely to be sub-prime lending, as up until recently, this type of customer has not been catered for in the large part.

### **Some countries will be more feasible for sub-prime expansion than others**

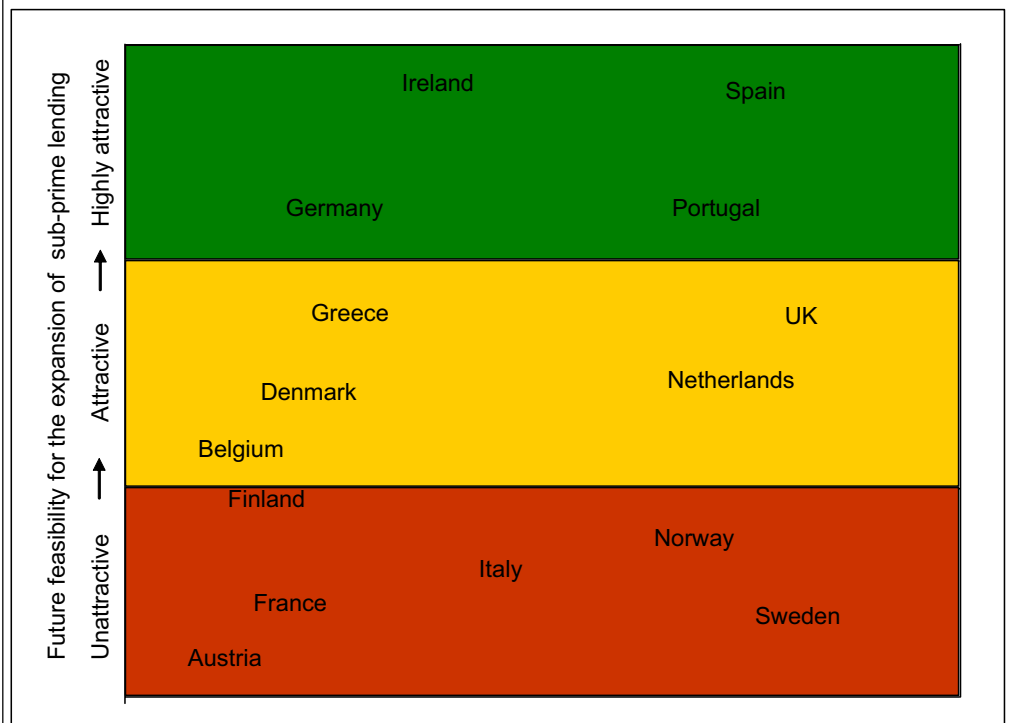
While sub-prime lending is likely to expand on the whole, development across Western European markets will vary. Unsurprisingly, as discussed, each country's development has differed historically. In turn, the degree of future expansion is also going to differ, due to the same variety of factors that impacted it historically, including:

- size of the sub-prime population;
- lender attitudes and criteria;
- regulatory climate;
- extent of competition;
- information gathering;
- economic condition and future certainty;
- government provision of credit to sub-prime individuals;
- distribution.

Conclusions

The graphic below conceptualizes Datamonitor’s opinion of the feasibility of sub-prime expansion across Western European markets, based on the analysis provided within the body of the report. Countries were separated into three broad categories for lenders; ‘highly attractive’, ‘attractive’ and ‘unattractive’. Obviously, those countries in the ‘highly attractive’ section are, in Datamonitor’s opinion, those markets best suited for lenders to reap the greatest benefits of sub-prime lending.

**Figure 11: In Datamonitor’s opinion, Germany, Ireland, Portugal and Spain are highly attractive sub-prime lending markets for the future, 2007**



Source: Datamonitor, primary and secondary research

**DATAMONITOR**

## Conclusions

### **Companies have a number of ways to become involved in the market**

Lenders can enter the market themselves or set up a separately branded subsidiary

With a large number of countries forecast to experience expanding sub-prime markets, lenders and non-lenders have a significant number of opportunities at their door.

Lenders have two main options:

- **entering into the market themselves** – existing mainstream lenders thinking of expanding into the sub-prime market are likely to first offer credit to near-prime customers. As already mentioned, it is difficult for mainstream banks to enter the sub-prime market due to a lack of specific skills needed to participate successfully in this sector. As a result, starting by lending to the near-prime sector is a more natural progression. Moreover, near-prime lending is not as much of a reputation risk as mid-to-heavy sub-prime lending.

A number of banks and finance houses have taken this step across Europe. Many UK building societies have launched into this sub-prime mortgage market, including the Derbyshire and Leeds Building Society. Meanwhile, Capital One engages in sub-prime and credit card lending using its primary brand. Elsewhere in Europe there are fewer examples, given that these markets remain undeveloped, however, *Cetelem* and *Cofidis* both do a certain degree of near-prime lending depending on the country in which they operate;

- **setting up a separately branded subsidiary** – lenders wishing to cater to the near-prime, or otherwise mid or heavy sub-prime sector, may consider setting up a separately branded subsidiary. Indeed, sub-prime lending in most countries is still not regarded in the same light as mainstream lending, with many sub-prime markets suffering from a tainted reputation. By separating the sub-prime subsidiary brand, its mainstream counterpart can avoid putting its reputation at risk.

## Conclusions

A number of examples can be found, particularly in the UK, including Amber Homeloans (subsidiary of the Skipton Building Society), and Platform (subsidiary of the Britannia Building Society).

Meanwhile, independent specialists can become involved. Often they will be owned by another lender or by an investment bank.

### Non-lenders can also participate in this market

Meanwhile, other companies looking to profit from the sub-prime market can also play a role. Datamonitor surmises that a number of investment banks will look to launch or buy specialist lenders with the intention of realizing profitability by funding through securitization.

### **Lenders should also be aware of the risks involved in sub-prime lending**

While the sub-prime lending sector has excellent prospects and offers participating lenders the potential to boost their profits significantly, it is important to remember that it is a more risky business than mainstream lending.

### In 2006 and early 2007 sub-prime mortgage firms in the US began seeing a large number of losses

As discussed previously, sub-prime lending has become big business in the US over the last two decades. Indeed, a number of significant mainstream lenders, including Citibank and HSBC, eventually became involved in these markets. However, recent developments in the US sub-prime mortgage market greatly reiterate the risks of the sector, with many lenders seeing significant losses or having to fold as a result of an unexpectedly high number of defaults.

The troubles began to brew in 2004, when some of the major sub-prime lenders began to compete for market share. Such competition led to very competitive rates for risky customers. Unsurprisingly, this led to a boom in new business as thousands of customers used these low rates to get onto the housing ladder, whereby it had previously been too expensive.

## Conclusions

However, the Federal Reserve continued to raise short-term interest rates, flattening margins. Lenders reacted by raising sub-prime interest rates, but also by relaxing their underwriting criteria in a further attempt to maintain new lending as before, as the housing market slowed. Moreover, lenders also offered negative amortization mortgages (whereby payments are so low that the overall debt gets bigger over time), as well as introductory rates whereby the long-term rate would jump up after a couple of years, which caused a large number of borrowers to no longer be able to afford their mortgage. More surprisingly, lenders offering borrowers these introductory rate mortgages followed by a long-term rate found that these borrowers did not switch after the introductory period ended, even though they were now paying a much heavier monthly repayment.

Once the housing market flattened and the economy weakened, defaults began rising. According to the Mortgage Bankers Association (MBA), at Q4 2006 fixed rate and adjustable rate mortgages (ARMs) were showing a delinquency rate of around 10 per cent and above 14 per cent respectively, whereas in Q4 2004, the delinquency rate for these loans were both at around 10 per cent. Indeed, at the end of last year, delinquencies of sub-prime mortgages amounted to 13 per cent of outstanding loans. Foreclosures of sub-prime mortgages amount to 4.5 per cent of outstandings.

### *A significant number of sub-prime mortgage firms are now in financial trouble*

A significant number of US firms in the sub-prime mortgage have gone out of business (around 25 or more), seen profit warnings or are currently for sale, including:

- New Century Financial, the second largest sub-prime lender in the US, edged closer to collapse in March 2007 after its creditors, including Barclays Bank, threatened to stop funding the company. The company's latest Securities and Exchange Commission filing showed that its cash reserves had fallen below US\$60 million (€45.7 million), putting it in breach of its banking covenants;
- in December 2006, Ownit Mortgage Solutions, closed its doors to business;
- H&R Block's Option One Mortgage is for sale, after the tax preparer posted a US\$44.7 million (€34.6 million) loss in the quarter ending in January 2007 after setting aside US\$111 million (€85.9 million) to cover losses on loans underwritten by Option One;
- in December 2006, KeyCorp sold its sub-prime arm, Champion, for an undisclosed sum thought to be well below the US\$200 million to US\$250

## Conclusions

million (€151.5 to €189.4 million) tag analysts had put on it, according to the Economist.

### ***Moreover, HSBC in the US is a prime example of an expedition gone bad***

In December 2006, HSBC cautioned at its pre-close trading update that bad debt trends among US mortgage borrowers were deteriorating at a faster rate than expected. The bank blamed the impact of slowing house price growth. It said that the level of loan impairment provisions for 2006 would be higher than was then reflected in market estimates. Analysts had previously expected HSBC to report a bad debt charge of US\$8.8 billion.

Then in February 2007, HSBC gave warning that bad debts in its US mortgage business would be twenty per cent higher than previously forecast. City analysts had expressed alarm at the time that customers were defaulting less than six months after taking out their loans, a situation viewed as virtually unprecedented.

HSBC's problems stem from its acquisition of Household International for US\$15 billion (€12.6 billion) in 2003. Later that year, executives began to expand HSBC's sub-prime mortgage book by offering introductory rate and second charge mortgages, which offer an initial period of low interest rates or carry a second claim on a property that is already mortgaged.

The alert deepens concerns over the ability of HSBC's US mortgage operations to model default trends accurately. When HSBC bought the operation it placed much emphasis on the strength of its computer intensive techniques to model consumer behavior. Before the acquisition, HSBC had no experience of lending in the US sub-prime market. Such a situation points out the dangers of going into the sub-prime market without considerable experience or expertise.

### ***Such a situation points to lenders who became too aggressive***

The situation in the US is one of lenders getting burnt by becoming too aggressive and not having their risk models up to standard (as well as some lenders practising irresponsible lending). Indeed, the current situation underscores the risks of sub-prime lending and the need to be consistent in risk-based pricing, rather than going after market share without keeping an eye on the basic models.

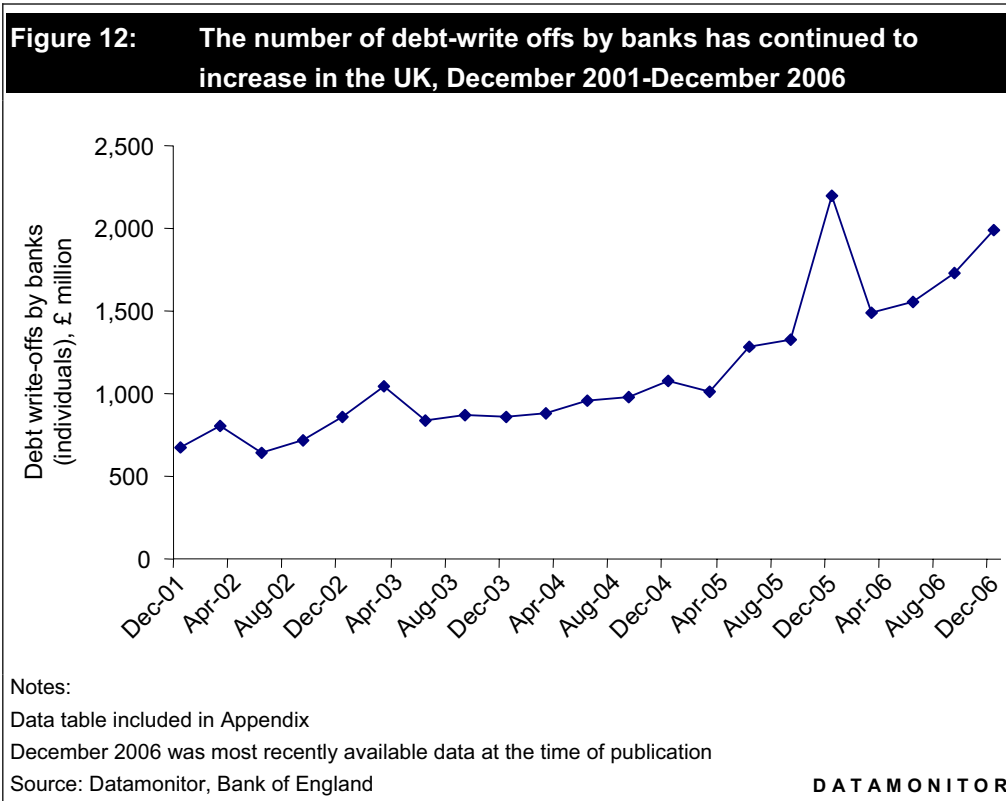
## Conclusions

### The UK has also become a more uncertain market

While not at all on a scale yet with the US, UK sub-prime lenders should also take note. The last couple of years have seen a number of high profile banks admit high debt write-offs – particularly on unsecured lending – as the number of those defaulting, taking out Individual Voluntary Arrangements (IVAs) and going into bankruptcy increased dramatically. Such lenders included Barclays and HSBC, among many others.

In fact, overindebtedness has been one of the major issues facing the UK consumer credit industry in the past few years. Fuelled by various factors such as a healthily growing economy, low interest rates, low unemployment and a rampant housing market, consumers were previously very willing to borrow and spend. However, in 2005 an increasing number of borrowers started feeling the pressure of high levels of indebtedness. This continued in 2006 with two further rises in the base rate, and then another in January 2007. Further, there are expectations of another rate rise in May. This concerning situation can be seen in the graphic below, which covers consumer debt write-offs by banks in the UK, highlighting the increasing number of debt write-offs since 2001.

Conclusions



*Sub-prime lenders in the UK need to ensure they do not make the same mistakes as those in the US*

As seen from above, UK consumers are increasingly finding it tougher to service their debts. As such, UK sub-prime lenders should be sure that their risk models are in excellent condition, and that perhaps they should implement lending criteria to remain on the cautious side. Most of all, they need to ensure that they do not make the same mistakes as those in the US did, by avoiding competition for market share which pushed down rates, down to an unsustainable level and to a point where too many customers were being accepted.

Indeed, it is particularly important that UK sub-prime lenders heed this advice, particularly during a time when interest rates are expected to increase one more time, and overindebtedness remains an issue.

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**For lenders who view sub-prime lending as too risky, other segments should be investigated**

While sub-prime lending can reap great rewards, it may be too risky for some lenders. Indeed, as European retail banking competition become tougher and margins become thinner, lenders who believe that sub-prime customers would not be a good fit for their business should investigate the wide array of other segments they could expand into. These include catering towards the self-employed, immigrants, the wealthy, among many others. Within the mortgage market there are a plethora of niche mortgages that could be offered, for instance, equity release schemes, graduate mortgages and self-build mortgages. Lenders must look for other opportunities out there, whether sub-prime or elsewhere.

### **European regulation could affect lenders in the future**

The European Commission (EC) is considering regulation on a European-wide basis in both consumer credit and mortgage markets. Indeed, such a task is highly complex given the differences between each European country's consumer credit and mortgage markets, and as such considerations have been an ongoing process for a number of years now.

The proposals are designed to improve transparency on consumer credit and mortgage products and allow easier comparison across the European Union (EU). The Commission believes that harmonizing consumer credit and mortgage rules across the EU will increase the protection of consumers and improve confidence in the provision of credit. It hopes that the proposals will strengthen the functioning and stability of European consumer credit and mortgage markets.

While there are bound to be a number of difficulties for each individual market's lenders, European integration will ultimately have a positive effect on the sub-prime market. Indeed, it will give the sector a better reputation by improving transparency and as a result, will most likely lead to an expansion of the sector through the participation of more lenders and a better marketplace.

## Conclusions

### A review of the European Consumer Credit Directive is expected in 2008

The European Consumer Credit Directive (CCD) is still being drafted but as it stands it will have wide-ranging implications across Europe. The European Commission proposed to revise the directive in September 2002. It is now undergoing a substantial review in the European Parliament and the Council of Ministers. The process of review is not expected to be complete until 2008. Following this, a revised directive will need to be enacted into national law so it is likely to be a number of years before any changes are made.

#### *But some are wary that it could affect the cost and availability of sub-prime credit*

However, there have been some rumbling and concerns on the proposed Directive. In a report put together by Oxera, commissioned by a number of UK industry bodies and associations – including the Association of Payment and Clearing Services (APACS), the British Bankers' Association (BBA), the Consumer Credit Association (CCA), and the Finance & Leasing Association (FLA) – to assess the impact of the revised versions of the proposed Consumer Credit Directive on credit for consumers and, more broadly, the UK economy, found that a couple of provisions will cause difficulty for sub-prime lenders. These are Article 7a, which imposes a statutory duty on the lender to undertake a creditworthiness assessment, and Article 5, which imposes a duty on credit providers 'to provide adequate explanations to the consumer, in order to put the consumer in a position to assess whether the proposed credit agreement is adapted to his needs and to his financial situation'.

Oxera argues that the proposed Directive, if implemented, could result in a serious impact on users of credit and the UK economy. Indeed, it argues that there would be a direct increase in the cost of providing credit due to the enforced duty to explain and the necessity of lenders to store more information about credit applications and assessments. Moreover, Oxera believes that there would be a reduction in the availability of credit particularly at the sub-prime level, as lenders cut back on supply as a result.

The report is limited to the UK, and as such, Datamonitor believes that such adverse effects would not be played out to the same extent across European markets, particularly as sub-prime consumer credit remains on a very small scale up to now. Indeed, even including the UK, with increasing competition across European

## Conclusions

mainstream consumer credit markets, lenders will view the sub-prime sector as an under-explored and margin-enhancing sector, notwithstanding the proposed new regulation.

### Possible European mortgage market integration is still a number of years away

*The European Commission has been pondering mortgage market integration for a number of years now*

The debate on European mortgage market integration continues and will be closely watched by lenders already in or considering entering Europe. It began with a forum group that was established by the EC in March 2003 with the task of considering the barriers to further mortgage market integration, and making proposals to tackle those barriers. Formerly, Charlie McCreevy, the EU's internal market commissioner had been a strong advocate of opening up the €4.0 trillion European mortgage market, which accounts for 40 per cent of the EU15's GDP.

A cost-benefit assessment of an integrated mortgage market was undertaken by London Economics, a private consultancy firm, with conclusions that one-off implementation costs for European lenders would be around £450 million and ongoing costs around £465 million. Upon the conclusion of this study, the European Commission in July 2005 decided to shelve the initiative until there was a demonstrable business case for it.

During summer and autumn 2006 the Commission hosted a series of meetings of the Mortgage Industry Consumer Dialogue Group (MICDG). In addition, the Commission established an expert group known as the Mortgage Funding Expert Group (MFEG), which reported in January 2007. Its report put forth a liberalizing agenda that focuses on the removal of national barriers to integration of funding markets and on the promotion of measures to liberalize the functioning of the market. The UK's Council of Mortgage Lenders (CML) welcomed the finds of the report, as a significant number of lenders are significantly wary of Brussels proposing regulations for a market that they believe it does not fully understand.

A white paper was expected in June/July 2007, but the EC has confirmed that it now expects to publish the white paper in September 2007.

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### *Lenders are waiting for the White Paper in September 2007*

Until September 2007 it will be difficult to assess the effect on sub-prime lenders, but it seems as if the EC is waking up to the likelihood that liberalizing funding markets and the functioning of the market will do more to enhance competition and benefit consumers than creating a single regulatory mold for the market. Such news will be welcomed by sub-prime lenders already in the market and those pondering a move into other countries. Moreover, investment banks would welcome a liberalization of funding markets, so that they could more easily enter European sub-prime mortgage markets by funding through securitization.

## CHAPTER 5 APPENDIX

This chapter presents data and information designed to support the main body of the report. Specifically, it provides the following:

- **Supplementary data** – all data tables for graphics presented in the preceding chapters and other data tables that Datamonitor feels may aid readers;
- **Definitions** – definitions of the key technical terms used in the brief;
- **Research methodology** – details of the process behind the compilation of this report and any specific datasets;
- **Relevant readings** – details of current and forthcoming Datamonitor publications related to this subject area;
- **Relevant links** – links to sources of information used in this report;
- **Datamonitor's custom research capabilities** – details of Datamonitor's custom solutions service;
- **Ask the analyst** – contact details for Datamonitor's financial services area.

## Supplementary data

Supplementary data tables related to Chapter Three: *The State of Sub-prime Lending Across Western Europe*

<b>Table 2: How has the proportion of customers that apply to your bank and are declined changed in recent years?</b>	
	<b>Mean indicator</b>
Norway	3.2
Denmark	3.0
Ireland	2.9
UK	2.8
Spain	2.7
Portugal	2.6
Italy	2.6
Germany	2.6
Greece	2.6
Belgium	2.6
France	2.4
Netherlands	1.9
Sweden	1.7
Austria	1.6
Finland	1.2

Note: Mean score calculated by a weighted scale from 1 to 5 where 1 denotes 'We have tightened our lending criteria considerably in recent years', 2 denotes 'We have tightened our lending criteria somewhat in recent years', 3 denotes 'There has been little change in recent years', 4 denotes 'We have relaxed our lending criteria somewhat in recent years', 5 denotes 'We have relaxed our lending criteria considerably in recent years'.

Source: Datamonitor's European Branch Manager Survey 2006

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**Table 3: Would you typically have problems lending to customers or reject customers outright who have a minor history of credit arrears?**

	<b>Mean indicator</b>
UK	2.1
Austria	2.1
Norway	1.9
Netherlands	1.9
France	1.8
Germany	1.8
Ireland	1.7
Denmark	1.7
Spain	1.6
Greece	1.5
Portugal	1.5
Italy	1.5
Finland	1.4
Sweden	1.2

Note: Mean score calculated by a weighted scale from 1 to 3 where 1 denotes 'Would not lend to them', 2 denotes 'Some problems lending to them but would not necessarily reject them outright', 3 denotes 'No problems lending to them'.

Source: Datamonitor's European Branch Manager Survey 2006

**DATAMONITOR**

**Table 4: Would you typically have problems lending to customers or reject customers outright who have a major history of credit arrears?**

	Percentage of responses, %
Denmark	100.0%
Greece	100.0%
Netherlands	100.0%
Italy	100.0%
Norway	100.0%
Sweden	100.0%
France	97.5%
Spain	97.5%
Germany	97.4%
UK	97.2%
Austria	97.0%
Portugal	96.7%
Finland	96.0%
Ireland	96.0%

Note: Belgium not included

Source: Datamonitor's European Branch Manager Survey 2006

**DATAMONITOR**

## Appendix

**Table 5: Would you typically have problems with lending to people with debt reconstructions on their record?**

	Percentage of responses, %
Denmark	100.0%
Greece	100.0%
Netherlands	100.0%
Norway	100.0%
Sweden	100.0%
Italy	97.5%
Spain	97.5%
France	97.4%
Finland	96.0%
Germany	94.7%
UK	94.3%
Austria	93.9%
Portugal	93.3%
Ireland	84.0%
Belgium	73.3%

Source: Datamonitor's European Branch Manager Survey 2006

DATAMONITOR

**Table 6: Mortgage and consumer credit gross advances in Ireland, 2001-2005**

€m	2001	2002	2003	2004	2005	CAGR, '01-'05
Mortgage gross advances	7,664	10,825	13,524	16,933	21,536	29.5%
Consumer credit gross advances	n/k	n/k	8,984	8,513	9,294	n/a

Notes:

Data table included in Appendix

Consumer credit data for 2005 is an estimate, while 2001-2002 figures were unknown

Source: Datamonitor, Central Bank of Ireland, Department of the Environment, Heritage and Local Government, Datamonitor estimates

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Supplementary data tables related to Chapter Four: *Conclusions*

<b>Table 7: Debt write-off by banks (individuals), December 2001-December 2006</b>	
<b>Debt write-offs by banks (individuals), £ million</b>	
31-Dec-01	676
31-Mar-02	801
30-Jun-02	637
30-Sep-02	717
31-Dec-02	858
31-Mar-03	1,043
30-Jun-03	838
30-Sep-03	872
31-Dec-03	857
31-Mar-04	880
30-Jun-04	959
30-Sep-04	981
31-Dec-04	1,072
31-Mar-05	1,013
30-Jun-05	1,283
30-Sep-05	1,326
31-Dec-05	2,192
31-Mar-06	1,485
30-Jun-06	1,550
30-Sep-06	1,728
31-Dec-06	1,986

Source: Datamonitor, Bank of England DATAMONITOR

## Definitions

### *Balances outstanding*

The value of loans outstanding at any point in time, usually year-end.

### *Gross advances*

The value of loans made over a period of time.

## Appendix

### *Sub-prime*

Sub-prime individuals are at the least worthy end of the credit spectrum. These individuals are rejected by mainstream lenders for a diverse set of reasons, such as bankruptcy, a history of mortgage or consumer credit arrears, or other poor records of payment in their credit history, such as bounced checks, unpaid household bills, and court orders, among others.

### **Research methodology**

This report was based on extensive primary research through in-depth interviews with executives in the lending industry. The report was further supported by extensive secondary research carried out through sources such as the Internet, lenders' websites, specialist magazines and the press.

In addition, Datamonitor conducted a large scale survey of 500 branch managers across Western Europe. The survey was conducted from September to November 2006.

To supplement this attitudinal survey, Datamonitor also held open ended interviews with senior head office staff (typically working within the bank's lending departments or in a strategic role) to examine the role of sub-prime lending and its development.

### **Relevant links**

This report was compiled on the basis of interviews with industry executives and extensive secondary research. Important secondary sources include:

- Banca d'Italia [www.bancaditalia.it](http://www.bancaditalia.it)
- Banco Primus [www.bancoprimus.pt](http://www.bancoprimus.pt)
- Bank of Greece [www.bankofgreece.gr](http://www.bankofgreece.gr)
- Banque de France [www.banque-france.fr](http://www.banque-france.fr)
- Conseil à l'Accession et au Financement en Prêts Immobiliers [www.cafpi.net](http://www.cafpi.net)
- Cetelem [www.cetelem.com](http://www.cetelem.com)

## Appendix

- CIA World Factbook [www.cia.gov/cia/publications/factbook/index.html](http://www.cia.gov/cia/publications/factbook/index.html)
- Citibank [www.citibank.com](http://www.citibank.com)
- Cofidis [www.cofidis.com](http://www.cofidis.com)
- European Central Bank [www.ecb.int](http://www.ecb.int)
- GE Money [www.gemoney.com](http://www.gemoney.com)
- GMAC-RFC [www.gmacrfc.com](http://www.gmacrfc.com)
- HFC Bank [www.hfcbank.co.uk](http://www.hfcbank.co.uk)
- Finagen [www.finagen.it](http://www.finagen.it)
- HSBC [www.hsbc.com](http://www.hsbc.com)
- Médiatis [www.mediatis.fr](http://www.mediatis.fr)
- RTE (Ireland's National Radio and Television Broadcaster) [www.rte.ie](http://www.rte.ie)
- Schufa [www.schufa.de](http://www.schufa.de)
- Sparck Hypotheken [www.sparck.com](http://www.sparck.com)
- Tiresias [www.tiresias.gr](http://www.tiresias.gr)
- Unión de Créditos Inmobiliarios [www.uci.es](http://www.uci.es)

### Relevant readings

- Bank Attitudes to Consumer Credit in Europe (DMFS1774), *published in November 2005*;
- Non-traditional Players in the Retail Banking Market (DMFS1893), *published in November 2006*;
- Online Banking Strategies in Europe 2006 (DMFS1950), *published in November 2006*;

## Appendix

- The Role of Complaints Management in European Retail Banks 2007 (BFFS0463), *published in February 2007*;
- Trends in Customer Loyalty and Acquisition Strategies in Europe 2007 (DMFS1995) – *published in February 2007*;
- Western European Consumer Credit 2006 (DMFS1889), *published in September 2006*;
- Western European Mortgages 2006 (DMFS1866), *published in April 2006*.

### **Future Readings**

- Consumer Credit in Hungary 2007 (Market Guide) (DMFS2132), to be published in December 2007;
- Consumer Credit in Poland 2007 (Market Guide) (DMFS2130), to be published in December 2007;
- Consumer Credit in the Czech Republic 2007 (Market Guide) (DMFS2131), to be published in December 2007;
- Mortgages in Hungary 2007 (Market Guide) (DMFS2129), to be published in November 2007;
- Mortgages in Poland 2007 (Market Guide) (DMFS2127), to be published in November 2007;
- Mortgages in the Czech Republic 2007 (Market Guide) (DMFS2128), to be published in November 2007;
- Western European Consumer Credit 2007 (DMFS2126), to be published in December 2007;
- Western European Mortgages 2007 (DMFS2125), to be published in November 2007.

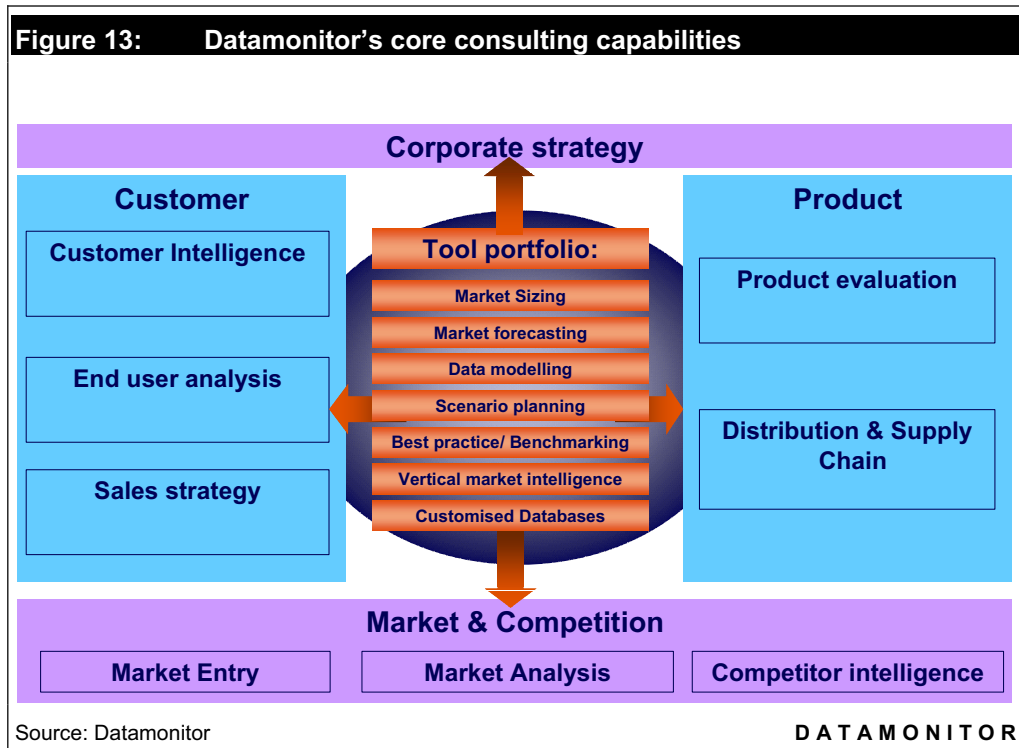
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