

## The Future of Sub-Prime Lending

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By Kapil Madan

Within the world of finance, 2008 is sure to be remembered as a year of turbulence, difficulty and change. Trillions have been poured into world banking systems, which came close to collapsing under the weight of their own innovations. Many of the world's largest economies entered recession, and the value of the UK pound sank below the Euro for the first time. The news headlines have teemed with stories of multi-billion pound frauds, bank collapses and financial woe. But perhaps the greatest victim of these changing times is our once-vibrant credit culture. Many organisations, including all the large banks, have fundamentally revised their attitudes to lending, both to individuals and to institutions. A desire for caution and conservatism has led to slashed lending volumes, near frozen inter-bank markets and a significant increase in the cost of funding. These are symptoms of a paradigm-shift which will leave the credit industry a very different place.

So, where does UK sub-prime lending fit into this new landscape? Does it have a place at all? Sub-prime lending is, by its very nature, far removed from the concept of conservatism and tightened acceptance criteria. Sub-prime, or 'non-standard', borrowers are those who cannot get credit from more mainstream lenders, usually because they are perceived as high-risk. This may be due to poor previous credit performance or even no credit history at all, but could also stem from factors such as low or irregular income, moving home several times, or being new to the country. Ironically, while the banks deemed such individuals within their own markets to be unworthy of credit, many were happy to invest in companies, directly or indirectly, which undertook this type of lending elsewhere. And now, as banks restrict lending and adopt risk-avoidance policies, the number of consumers falling into these 'non-standard' categories is actually growing.

The sub-prime lender views these 'non-standard' consumers in a different way. By looking beyond the credit report and understanding the consumer's true situation, and by applying processes and tools refined for this sector, this lender believes that controlled and profitable lending is achievable. It may be that the application process is more interactive and detailed, that the collections strategy is more intensive and requires more resource, and that the final loss rates run at a higher level, but by pricing the credit appropriately and controlling exposure, profit can still be maintained. Historically this has certainly proved to be the case, with sub-prime lenders recording large profits and showing significant expansion during the boom years. Driven by a benign economic climate and rocketing house-prices, coupled with readily-available and cheap funding, the sector can cite several success stories to vindicate the decision to operate in this market.

But now the economic landscape is a different and less friendly place. The question remains – does UK sub-prime lending have a future in this changed world? The reputation of the sub-prime sector as a whole has been tarnished by events in the US, where it is has been identified as a primary trigger of the ‘credit crunch’. There the ownership of risk became removed from the ownership of risk control, with the inevitable results having far-reaching effects. And now funders and analysts around the world are realising that they don’t really understand these businesses; share prices have varied wildly and funding has disappeared or become prohibitively expensive. The owners and backers of these sub-prime lenders have realised that they need a clear picture of performance and value, so that they can evaluate the true worth and future of these businesses in these difficult times.

So what is it that differentiates a profit-making, future-proofed sub-prime enterprise from the unprofitable ones? This question has been asked by many recently, not least the FSA. Taking a close look at the FSA’s risk assessment framework, appropriately named ARROW (Advanced, Risk -Responsive Operating FrameWork), helps to understand their thinking. The ARROW risk model provides an overview of how inherent business risks, front line controls and governance arrangements interact within a firm or a group, leading to an overall assessment of net risk. Risks arise because of the environment and the business model. They can be mitigated or reduced using front line controls, oversight and governance, and by maintaining excess capital and liquidity. Based on this, ARROW has divided the different risks into ten separate risk groups as can be seen below:

Environmental	Business Model	Front-Line Controls	Oversight & Governance		Other Mitigants	Net Probability
Environmental Risk	Customers, Products & Markets	Customer, Product & Market Control	Control Functions	Management, Governance & Culture		Customer Treatment & Market Conduct
	Business Process	Financial & Operating Control				Operating
	Prudential	Prudential Risk Control				Financial Soundness
				Excess Capital & Liquidity		

For each risk group, the FSA has also published a number of risk elements. For example, for the Environmental Risk Group the risk elements are: economic environment, legislative/ political environment, competitive environment, and the capital market efficiency. The credit crunch, while seeming to many to be an unpredictable ‘bolt from the blue’, was driven primarily by capital market (in-)efficiency - and it is interesting to know that the FSA has thought about this for a number of years. So why did no one foresee the flaws in the Northern Rock business model? Probably because to assess overall risk, both the impact and the likelihood of an event



are combined. Hence even a high impact event could fall below the FSA's radar if the probability of it occurring is considered sufficiently low. It would be interesting to learn what occurrence probability was assigned by the FSA to a 'credit crunch' magnitude scenario at the beginning of 2007.

What the ARROW model does achieve is to demonstrate that with the right amount of liquidity, along with appropriate front line controls and governance, business risks can be managed. Successful sub-prime lenders will be those who can demonstrate that they understand their business risks and the market forces and have suitable controls and mitigants in place. Those who do not take these steps and leverage this understanding will fall by the wayside, unlikely to emerge from the difficult conditions of the next few years.

A few sub-prime lenders are taking up this challenge. They are focusing their efforts on putting in "visible" controls that can be audited by their investors and lenders. They are developing insightful management information that identifies the key business risks and the drivers of profitability in their portfolio. Attempts are being made to understand the impact of changes in economic and social environment on the portfolio mix and proactively change policies and pricing. Regular portfolio valuations are being conducted using prudent account level cash-flow forecasts to understand and clearly communicate the real value embedded in the business. Moreover, traditional banking risk tools, like new business and secondary sales scorecards, are now being built and deployed in the sub-prime world to supplement existing decision making processes. Finally, these lenders recognise that building and deploying tools and reports is not the end game in itself. They are also redefining their oversight and governance frameworks by strengthening their operational audit teams and setting up risk committees that monitor the changing risk patterns on a regular basis.

Whether these efforts are sufficient to convince the heavily bruised investors and warehouse line providers is yet to be seen. But one thing is certain - the sub-prime lenders who are re-enforcing their risk management foundations will have an upper hand when the market mood swings. And in the meantime, if these sub-prime lenders are successful in implementing these crucial changes and start attracting new investments and cheaper warehouse lines, then they will not only survive but also flourish as the large banks merge and contract.

For more information about Euristix's approach to management of sub-prime companies and portfolios please contact Kapil Madan via the online form at [www.euristix.com/contact.php](http://www.euristix.com/contact.php)