PCP Finance – **Motor Industry Saviour or "Auto Loan ABS" Bubble?**

PCP (Personal Contract Purchase) finance might just have been the Car industry's saviour following the global economic crash, PCP plans offer motorists much easier access to finance a new car.

The more astute of you will note that I am not saying this is a method of purchasing a new car!

Traditionally, to purchase a new or nearly new car, most of us utilised either Bank finance via a term loan or entered into a HP agreement where at the end of the term we owned our own car.

There has been a fundamental change in the way that car finance is now being offered with the PCP plans being the most popular. The PCP model moves us away from the previous norm, where at the end of a finance term we own our cars, to a more lease or rental style agreement when at the end of the term we are required to pay the agreed residual value of the car in order to own it.

Motor dealers and Bankers alike know that when customers utilise PCP finance, almost no-one purchases the car at the end of the term, they merely step into a new PCP and start again so as to avoid a final balloon payment and to avoid losing any equity built up over the period of the contract. That usually guarantees brand loyalty and gives dealers some certainty on future sales orders.

PCP explained:
A car buyer agrees to pay a minimum deposit upfront (usually between 0% & 30% value of the vehicle), the buyer

then agrees with the dealer the level of monthly instalments, usually lasting for 36 to 48 months (in the US some have been extended out to 84 months). Then the buyer is advised of the Guaranteed Future Value (GFV) of the vehicle at the end of the agreement (see below).

The GFV is dependent upon your sticking to the agreement which may refer to matters such as keeping the car in good order, regular servicing, maximum mileage etc.

At the end of the PCP period you then have three options:

- Return the car and walk away
- Pay the amount of the GFV and own the car or
- Utilise the GFV to part exchange for a new car and start the process again.

There are advantages and disadvantages to each of the above options so you really need to decide what your needs and requirements are before choosing your option.

GFV

The GFV is calculated by the finance provider who runs its modelling programme to estimate the future value of the car at the end of the term, it builds in the risk factor, delinquencies, motor trends etc. and also ensures that the GFV will provide enough equity for the user so they may use the equity as the deposit for the next PCP.

In Ireland PCP plans are especially popular with VW indicating that it accounts for over 50% of new car sales throughout their range of offerings (VW, Audi, Skoda & SEAT).

One reason for that popularity is that VW who operate their own bank can offer very low interest rates when compared to many other manufacturers who offer finance in conjunction with Irish Banks.

Another significant effect on the PCP offering is that customers are likely to show loyalty to the brand if using the GFV to part exchange.

When a promotion is run by VW for example on a Skoda Octavia, VW have already agreed a deal with the factory making the vehicles for say 400 Octavia's for the Irish Market built to a specific specification and therefore they can agree and obtain a significant discount on the cost price for placing such an order, these savings then allow VW Bank to sell the PCP finance for the vehicles at 0% making it very attractive for us the motorist.

Second Hand Car Values

Until quite recently the supply of second hand cars in the global market place was quite limited, the advent of PCP plans in the past 5 years or so made it more attractive to possess (not own) a New car in the driveway, however the supply of second hand cars in Ireland is slowly increasing over the past two years or so, due to a combination of factors:

- the first of the PCP agreements ending
- recent increased imports from the UK (71,000 in 2016) – although the unknown impact by Brexit now exists for 2017

Arguably any increase in supply of good quality second hand cars could threaten the continued growth in the new car market but a Motor Dealer I spoke to recently said the Car dealers have no worries on that front and PCP is the way forward. (Then again one would expect a car dealer to say that).

He informed me that 70% of all his car sales (across 3 brands) are by way of PCP finance and he believes this is similar for all Irish car dealers.

The advent of the PCP plans has surprisingly, not been missed by the Markets, who are always keen to get a piece of the action.

PCP Asset Backed Securities

The interesting point arising from all of these new cars being financed with PCP funding is the offering to the markets (especially in the UK) of PCP Asset backed Securities.

In the UK in 2016, households borrowed a record GBP £31.6bn to purchase cars, up 12% on 2015 and a portion of these loans; whether HP agreements or PCP plans are being packaged and offered for sale.

There is a recent offering of an Asset Backed Securitisation of Auto Loan Receivables originating in the UK of Class A & B notes to be listed in the Luxembourg Stock Exchange.
This offering of receivables which are being sold by VW Financial Services (UK) arises from both HP (5,608 agreements) & PCP Agreements (37,789 agreements) and total GBP £750m.

The International Credit Rating Agency **ARC Ratings SA** have classified the above offerings as AAA(sf)(ind) with stable outlook for A Class, and A+(sf)(ind) with stable outlook for the B notes.

Of course, this is not the first of its kind to be offered on foot of PCP loans in the UK or the US and certainly won't be the last however the sale of these securities have led to a significant level of chatter in the market with the words subprime being mentioned.

In January 2017, Bank of England indicated that consumer credit in the UK including car loans was rising significantly and close to 2008 levels, however that in itself is not necessarily an issue. The question is the quality of the borrower and their credit scores which if found to be low may then be a reason to give some cause for concern.

In its previous loan offering in June 2016 VW Financial Services UK ltd. (Compartment private Driver UK 2016-1) it was stated in the prospectus **"The uncertainty of a vehicle's residual value represents a major risk for creditors of a financing contract, primarily when obligors opt to terminate their contracts voluntarily in the end or end of the term"**

Arguably, one of the reasons why the quality of these loans should be given consideration is that Multiple Banks will be involved in any such Auto Loan asset backed security sales. One such loan issued by an arm of Peugeot in 2015 valued at GBP£1.3bn included HSBC, Lloyds, Wells Fargo and BNP Paribas.

Conversely, when weighing up the effect of any collapse in these securities, it's also clear the auto loan market does not compare with the size of the mortgage market. Take the US, in 2015 auto loans to the prime and subprime borrowers topped $1 trillion compared to $8.4 trillion mortgage market.

The data available from the ratings agencies regarding the level of impairments on car loans in the UK versus the US is interesting:

- In the Peugeot loan book mentioned above Adrian Dally, the head of the Finance and Leasing Association in the UK indicated the delinquency rate is just 0.08% and Standard & Poor's said in February of 2017 that impairments on car loans in the UK & Europe were running at 0.2% of outstanding loans.
- Fitch Ratings predicted a 10% delinquency rate in the US for 2016 but stated that was still below the rate for 2008/2009, however Bloomberg reported last month (Feb 2017) that delinquencies among lower rated borrowers has risen to the highest level since 2009 and that amount of auto loans is growing at the latest pace on record.
- I believe it would be very interesting to see the current delinquency rates of Irish Bank backed PCP offerings and if we are as good as the European or US statistics.

With the current uncertainty in both the US and UK economies arising for differing reasons, it appears that market analysts are watching these asset securitisation offerings very closely as should delinquencies continue to rise in uncertain times, any collapse of the auto loan offerings could well result in the next "Big Short".

So, is this something that analysts and markets should be concerned about? Will the finance models used to predict the price of second hand cars coming off PCP stand up and prove to be correct?

Or is PCP finance just the new way of selling more cars, allowing the market to take a punt when we are assured by the ratings agencies that there is minimal risk.

It may well prove to be an Interesting time for many Irish Motor dealers in the coming 18 months!!

"The uncertainty of a vehicle's residual value represents a major risk for creditors of a financing contract, primarily when obligors opt to terminate their contracts voluntarily in the end or end of the term."

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