Commentary

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Insight beyond the rating.

U.K. Autos: Elongated PCP Terms Increase the Risk of Voluntary Termination

DBRS has observed an increase in the use of personal contract purchase (PCP) agreements in the United Kingdom over the last ten years. Furthermore, the use of PCPs has evolved over this period with the product now regularly used to finance new and used vehicles, while contract terms have also widened. In DBRS's view, the extended duration of these agreements creates an increased risk in the auto financing market from voluntary terminations.

What is a PCP?

Under a PCP agreement, a borrower pays a fraction of the vehicle's purchase price as a deposit and pays equal monthly instalments during the life of the agreement (typically three to four years). The finance company retains vehicle ownership, and the borrower has the option at maturity to either:

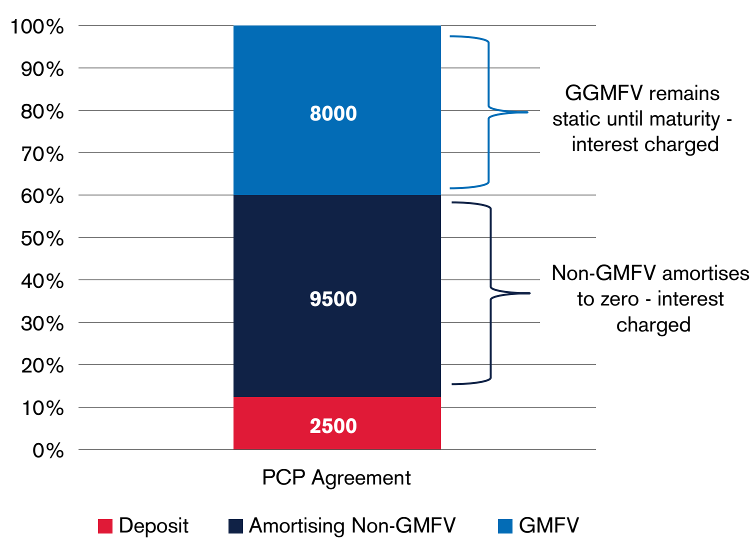
- Take ownership of the vehicle by making a final larger balloon payment (the guaranteed minimum future value (GMFV); or
- Return the vehicle to the lender.

In the case of the latter, the lender relies on the proceeds of the sale of the vehicle and potentially additional borrower payments to cover excess wear and tear charges (e.g., condition, service, mileage, etc.) to settle the underlying PCP agreement. A healthy used vehicle market typically ensures that vehicles are returned and remarketed at their forecasted value at the end of the PCP agreement.

A lender's approach in setting the GMFV in comparison with the vehicle's expected value at maturity may vary. Typically, a lender would seek to align the forecasted value of the vehicle with the GMFV to maintain a balance between competitiveness of the customer's monthly instalment and the residual value risk to the lender. An inflated GMFV, compared to the expected market value, would lower a customer's monthly instalment (making it more attractive) but would increase the lender's risk of (1) the customer returning the vehicle at maturity and (2) the lender not being able to sell the vehicle at a price to cover the outstanding finance balance.

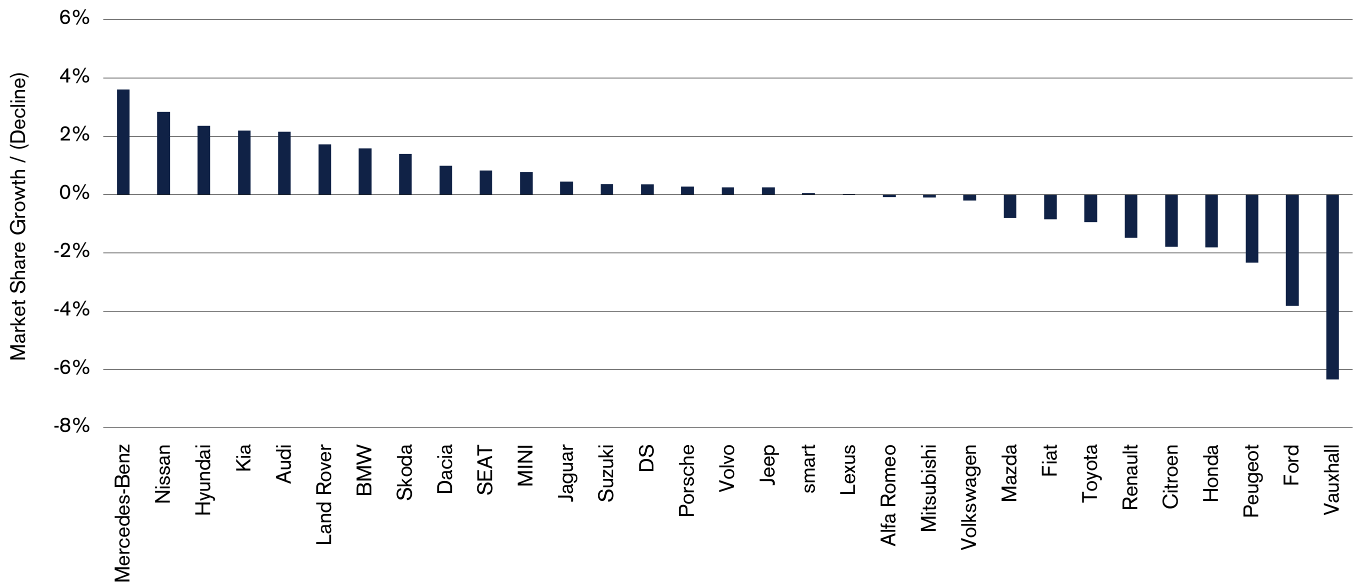
PCPs allow vehicle manufacturers, typically through their own captive finance units, to present an affordable monthly payment to a customer by amortising only the loan balance greater than the GMFV while charging interest on both the GMFV and non-GMFV element.

Exhibit 1: Example of a PCP Agreement



The adoption of PCPs by finance companies, dealers and customers alike has contributed to the growth in new vehicle sales leading up to Q2 2017. Their role in the growth of the market has been particularly evident in supporting increased sales of premium brand vehicles, allowing an affordable monthly instalment to be offered despite a high full retail price. Exhibit 2 below shows the change in market share by vehicle brand over the last ten years where growth has been observed in some of the premium brands (Mercedes-Benz, Audi, BMW and Jaguar Land Rover), offsetting considerable declines in the traditional mass market brands of Vauxhall, Ford, Peugeot, Citroën and Renault.

Exhibit 2: Market Share Variance - 2017 versus 2008



However, while the use of PCP agreements has increased new vehicle sales by making desirable but expensive cars seemingly more affordable, the product has evolved over time. In particular, DBRS notes a much wider use of four-year term PCP agreements in lieu of the traditionally used three-year alternative.

While this increase may not appear substantial, it has led to a change in customer behaviour, specifically with regards to the *Consumer Credit Act*, where, under Section 99 and 100, a borrower is entitled to terminate an agreement after paying the lender half of the total price. This is referred to as a voluntary termination (VT).

Following a deterioration in cumulative VT rates among U.K. auto asset-backed security (ABS) transactions, DBRS has assessed a basket of vehicles and analysed PCP offers on a three- and four-year basis to evaluate the impact of the growth in four-year PCP agreements.

In essence, once a customer pays 50% of the total amount payable under the auto finance contract (which includes interest, fees and the GMFV), they are permitted to return the vehicle to the credit provider and would only be liable for any costs if reasonable care has not been taken of the vehicle.

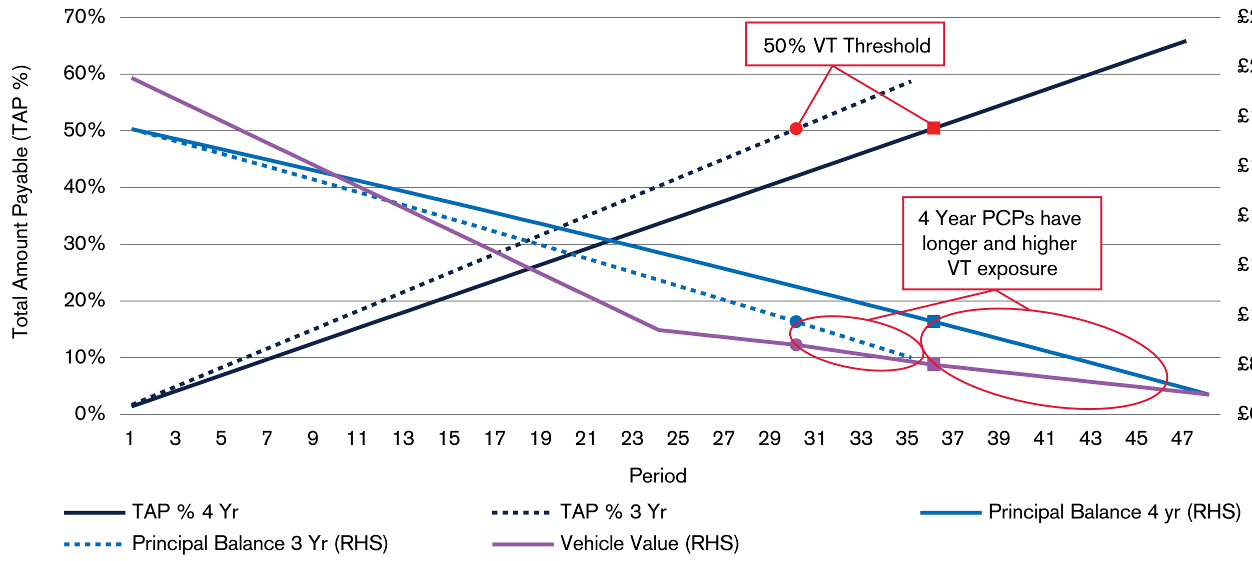
The GMFV set on a four-year PCP agreement is lower than that of a three-year agreement, reflecting the age and additional depreciation of the vehicle. The customer, although making lower monthly payments in a four-year PCP, repays more of the principal balance as a percentage of the total amount payable prior to the point when a decision is made to pay the GMFV or not.

This subtle difference means that a customer has a longer window to consider a VT and, at the 50% threshold, the severity of the VT loss to a lender (the difference between the outstanding balance of the PCP and the value of the vehicle) is higher when compared to a three-year agreement.

As an example, the following variables have been considered:

Retail Price of Vehicle	£20,000	Depreciation @ 2 years	53%
Deposit (Contribution)	£1,500	Depreciation @ 2.5 years	56%
Deposit (Customer)	£1,000	Depreciation @ 3 years	60%
Total Amount Financed	£17,500	Depreciation @ 3.5 years	63%
		Depreciation @ 4 years	66%
Interest Rate	5.0%		

Exhibit 3: VT Risk – Four-Year versus Three-Year PCP

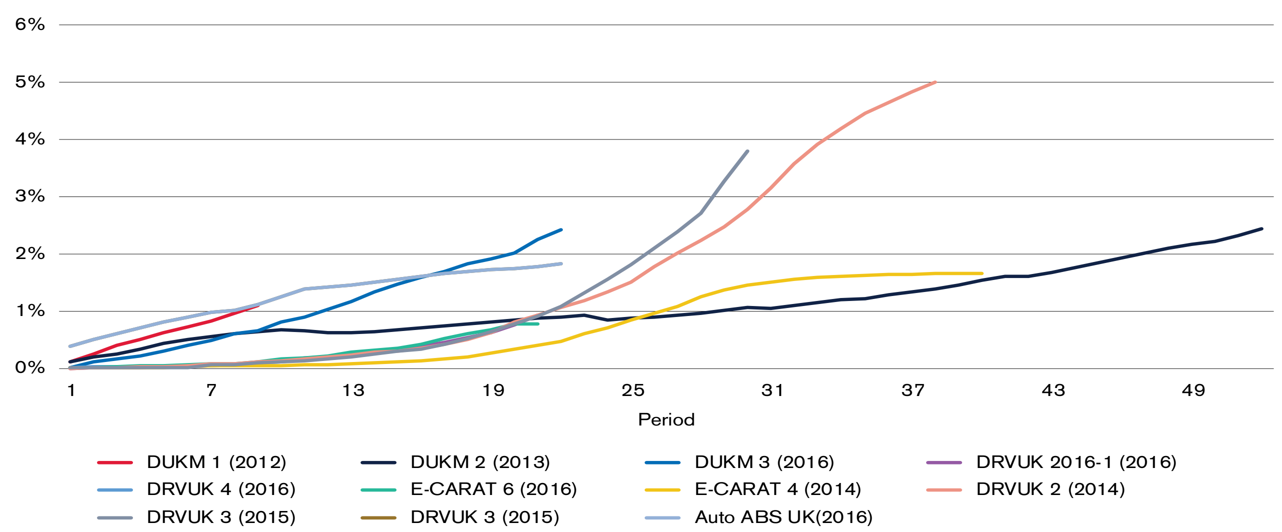


Under a three-year PCP, the 50% threshold is reached around month 30, leaving only six months until the final payment is due. However, under a four-year PCP, the customer would reach the same point around month 36, leaving a year for a VT to be considered. Additionally, due to the amortisation profile of the PCP agreement, the delta between the principal balance of the contracts and the vehicle value is greater under a four-year PCP.

DBRS estimates that the VT exposure to the lender is almost doubled under a four-year PCP compared to a three-year PCP when deposit and interest rate variables remain constant. To offset the negative impact of an increase in tenor, the four-year PCP agreement would have to be structured with a substantially higher deposit.

As four-year PCP agreements have become the norm, DBRS has observed increased cumulative VT rates for U.K. auto ABS transactions that it rates. While the trends are evident, the impact on the rating of a transaction may vary due to turn-in rate and RV loss assumptions at higher rating levels. However, an increase in VTs typically results in a lower recovery rate compared to a PCP at maturity while also denying the transaction additional cash flows and yield due to the early termination.

Exhibit 4: Cumulative Voluntary Termination Rates



U.K. auto ABS transactions have multiple performance variables that also include credit losses from defaulted contracts, turn-in rates at contract maturity and stresses related to market value decline. DBRS will continue to closely monitor developments in the U.K. auto market and their potential impact on DBRS-rated deals.