Recommended reading

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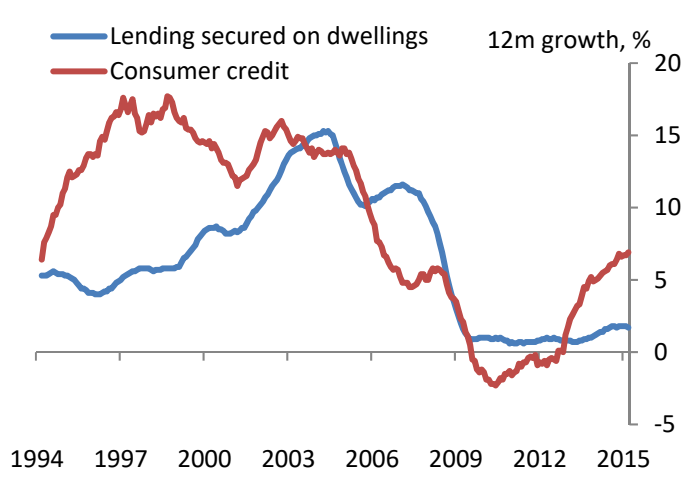
WHAT SHOULD WE MAKE OF THE RECENT STRENGTH OF CONSUMER CREDIT?

- **Supply conditions in consumer credit markets can exert a significant influence on overall economic activity, contributing to both the collapse in GDP during the crisis and the subsequent recovery.**
- **To some extent the recent strength of consumer credit growth reflects rising demand for consumer spending as confidence grows. However, we also see an important role for developments easing credit supply conditions, some specific to the consumer credit sector and others more general.**
- **The fact that unsecured lending spreads have fallen in the recent past and are expected to ease a little further supports GDP growth over the forecast, and we expect consumer credit growth to remain robust. However, if a shock were to cause bank funding costs to increase sharply, a contraction in consumer credit could play a significant role in propagating this.**

Consumer credit growth has outstripped secured lending growth since 2012

1. Since 2012, households have been increasing their unsecured borrowing at a much quicker rate than their secured borrowing (Chart 1). In the year to March 2015, consumer credit[2] grew 6.9%, compared to secured borrowing growth of 1.7%. This note looks at consumer credit – why it matters, what has caused the strength in lending growth, and whether it will continue.

Chart 1: Household borrowing



Consumer credit matters for GDP

Unsecured credit spreads appear to be particularly important for GDP

2. Despite the stock of outstanding consumer credit (£170bn [3]) being only 15% of that secured on dwellings (£1303bn), changing supply conditions in the consumer credit market can have a disproportionate impact on GDP. For many households, unsecured borrowing is the marginal source of finance for consumption. As such, the cost and availability of unsecured debt is likely to be a key factor affecting household spending.

3. Movements in consumer credit can be caused by movements in consumption and GDP reflecting demand shocks. But supply shocks (to the price or availability of credit) can also cause movements in consumer credit, which in turn causes movements in consumption and GDP, which in turn effects business investment, with imports acting as a slight offset.

An easing in credit conditions – and unsecured credit conditions as a significant component of this – is estimated to have boosted GDP growth by around 1pp over the past year

4. Our proxy measure for supply is our credit spread adjustment[4]. We can use our sectoral model to calibrate the impact of changes in credit spreads on the expenditure components of GDP using historical data. We estimate that the large rise in unsecured spreads in between 2007 Q3 and 2010 (Chart 2) was a significant drag on the level of GDP, relative to its pre-crisis trend (Chart 3). In the sectoral model, a 100bps shock to unsecured spreads is estimated to reduce the level of GDP (consumption) by 0.4pp (0.8pp) over the first year. The sectoral model is used to estimate the impact of credit spreads in the forecast. For more details on the specification of the sectoral model please see the Draft Working Paper As movements in spreads are often correlated, we have more confidence in our mapping between aggregate credit spreads and GDP (the combined green and

[1] With thanks to colleagues in BIAD, CAPD, MASD, MRD, PRA & SRDD for input and comments.
[2] Throughout consumer credit excludes student loans. Some consumer credit can be secured on assets other than dwellings (e.g. cars).
[3] .
[4] The credit spread adjustment is a measure of the marginal cost of credit relative to risk free rates

purple bars) than the precise sectoral split. However, these estimates of the importance of unsecured spreads accord with our view that consumer credit is important for marginal borrowing and spending decisions.

5. Over the past two years, credit spreads - and unsecured spreads as a significant component of this - are estimated to have boosted GDP growth relative to its pre-crisis trend (Chart 3). This is due to a combination of the effect of falls in spreads from their peak in Dec 2011 (Chart 2) and the levels drag from the initial rise in spreads waning slightly. As these falls continue to pass through, and as we expect further slight falls in unsecured spreads over the forecast, the boost to GDP growth, relative to trend, persists over the forecast.

6. Therefore movements in consumer credit are estimated to have been important for GDP recently and are expected to continue to matter over the forecast. Consistent with that, we expect consumer credit growth to remain robust over the forecast, but how sure are we that the recent strength will persist? The next section analyses the drivers of consumer credit growth over the past to shed light on this.

Chart 2: Credit spreads relative to 2007 Q3

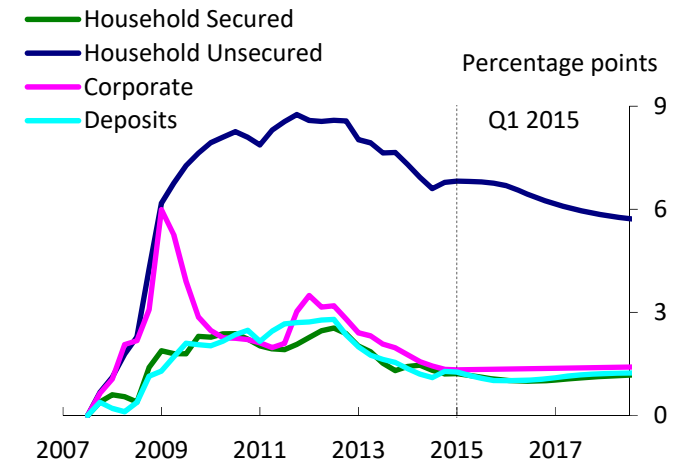
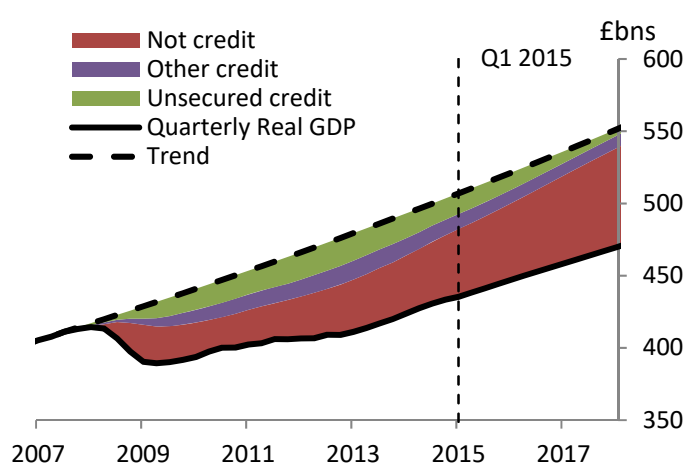


Chart 3: Effect of credit spreads on GDP growth forecast relative to pre-crisis trend



Why has consumer credit picked up since 2012?

7. Following the sharp fall in consumer credit growth during the crisis, net lending on consumer credit turned positive in 2012 and consumer credit growth overtook secured lending growth. Around the same time, unsecured credit spreads began to fall back.

Falls in bank funding costs have led to a generalised easing in credit conditions

8. In part, the fall in unsecured spreads reflects a decline in funding costs. Since the beginning of 2012, and in particular since the initial FLS announcement in mid-2012, bank funding costs have fallen significantly (Chart 4) and these reductions in costs have been largely passed on to households and corporates in lower lending rates. Between June 2012 and April 2015, spreads on our weighted average rates for household secured lending, household unsecured lending and corporate lending fell by 139bps, 181bps and 183bps respectively (Chart 2), while spreads on 5 year senior unsecured bonds fell by 134bps.

Table 1: Why has consumer credit picked up since 2012?

	Detail	Important?
SUPPLY	Fall in bank funding costs has driven generalised fall in credit spreads	Very
	Greater availability/ accessibility of specifically consumer credit	Yes
INTERACTION WITH DEMAND	Increased consumer confidence	Yes
	Spillover from relatively tighter conditions in some other credit markets	Little evidence

Chart 4: Bank funding spreads

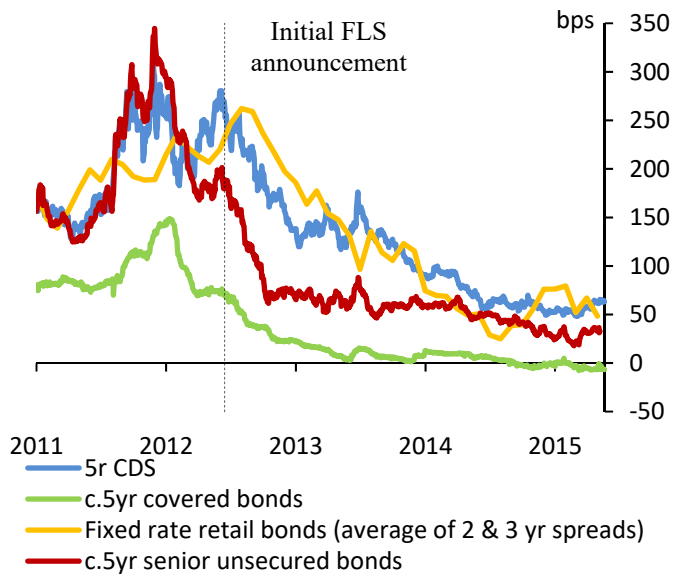
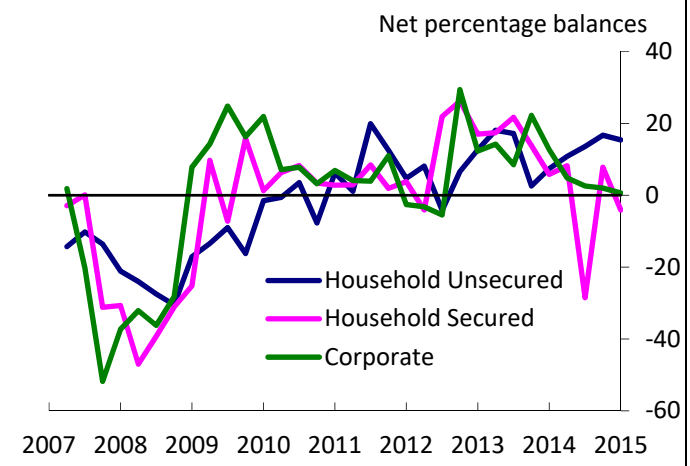


Chart 5: Change in credit availability, CCS



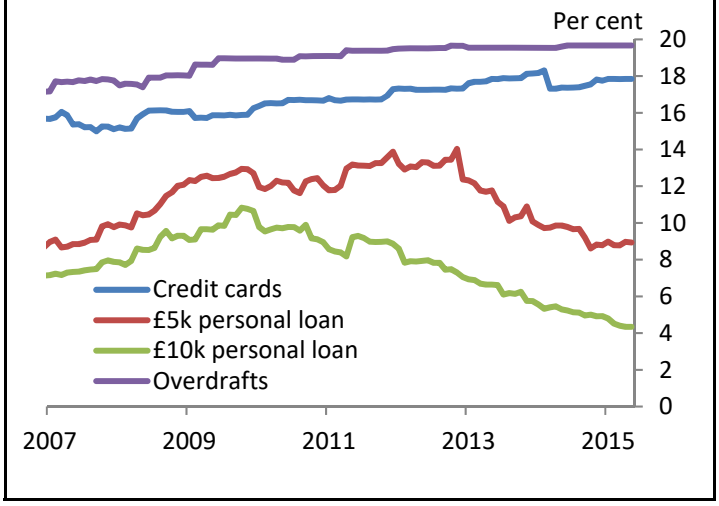
* A positive balance indicates that credit is more available than it was 3 months ago. Net percentage balances are calculated by weighting together the responses of those lenders who answered the question:

But there has also been some additional increase in availability/accessibility for consumer credit

9. There is some evidence, at least recently, for an additional increase in the availability and accessibility of consumer credit, over and above the generalised trend in improving credit availability for all types of credit. Over the last year in the Credit Conditions Survey (CCS), credit availability is reported to have increased more for household unsecured credit than household secured credit and corporate credit (Chart 5). Previous to that, in 2012 and 2013, lenders reported credit availability increasing for all types of credit at roughly equal rates, reflecting the general trend of improving credit conditions discussed above.

10. In a recent series of calls by the Bank Lending Monitoring Team (BLMT) in SRDD (see) the big 6 lenders cited particularly strong competition on rates on personal loans. The weighted average quoted rate[5] on £10k loans is currently 4.3%, a record low (Chart 6). Supermarket banks are competing hard. 3 of the 4 best available rates on Moneyfacts for £10k personal loans are currently offered by supermarket banks, with M&S Bank offering the best rate of 3.6%. Peer to peer lending remains small, but some lenders are also competing in segments of this market, with Zopa offering 3.8% on a £10k personal loan.

Chart 6: Unsecured lending rates



11. The lenders are obliged to offer 51% of loans at advertised rates, but borrowers of worse credit quality will generally be offered higher rates. Some lenders have reported that online and mobile channels had made it easier to target customers with unsecured credit offers, using for example personalised loan rates. There is some evidence that the fall in personal loan rates has brought in a higher credit quality of borrower with the latest CCS reporting an increase in the credit quality of non credit-card borrowing.

12. The quoted rates on credit cards have remained flat (Chart 6) but we think there has nevertheless been an easing in credit conditions in this market, mainly through other terms. The prime area of competition has been on the length on interest free balance transfer periods. The average length of interest free balance transfer periods offered has increased from 15 months in June 2012 to 22 months currently, and 36 month periods are available. A few lenders reported an increased offering of credit card products for those with poorer or little credit history (e.g. starter cards, initial cards), possibly following tighter restrictions on payday lending.

[5] The Bank's quoted rates series are weighted averages of rates from a sample of banks and building societies with products meeting the specific criteria (see www.bankofengland.co.uk/statistics/Pages/iadb/notesiadb/household_int.aspx).

13. .

Increased consumer confidence has played a role

14. While credit supply does appear to have improved, we also think that credit demand has increased and contributed to the pickup in lending.

15. Our best guess is that most of the pickup in consumer credit net lending has been accounted for by increased car finance and higher growth of personal loans. A third of the pickup can be attributed to motor finance, and a slightly larger proportion of the pickup is within "other" which includes personal loans and car finance which can't be identified (Table 2).

Table 2: Breakdown of consumer credit net lending

£bn, NSA	2012	2014	Difference (14-12)
Total consumer credit	2.2	10.4	8.2
o/w Credit cards	1.1	2.9	1.8
o/w Overdrafts (MFIs)	0.1	-0.6	-0.8
o/w Other personal loans	0.9	8.1	7.2
o/w Identifiable motor finance [(a)]	2.1	4.8	2.7
o/w Other [(b)]	-1.2	3.3	4.5

(a) Includes motor finance by non-MFIs and Blackhorse
(b) This will include any car finance provided by MFIs other than through Blackhorse, and other personal loans provided by MFIs and non-MFIs (e.g. personal loans for debt consolidation, car finance, home improvements, other purposes; retail & store credit)
The split between car finance and other is unpublished and

16. That is consistent with evidence from the CCS: while the balances on changes in credit demand are volatile, on average since 2012 lenders have reported a slight increase in households' demand for non-credit card consumer credit, for example personal loans (Chart 7). That increase in demand has occurred as the GfK consumer confidence balance has picked up over the last two years, and the major purchases balance within this has followed a similar path (Chart 8). And in ONS data, household vehicle consumption grew 17% between 2012 and 2014, explaining 0.7pp of the 4.3% rise in overall household consumption over that period. As such, there is some evidence that an improvement in demand has been a contributing factor to the strength of personal loans and car finance.

Chart 7: Change in demand for credit by households, CCS

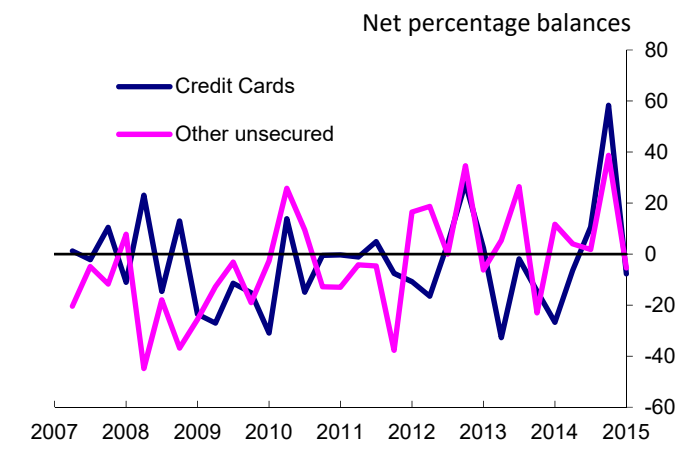
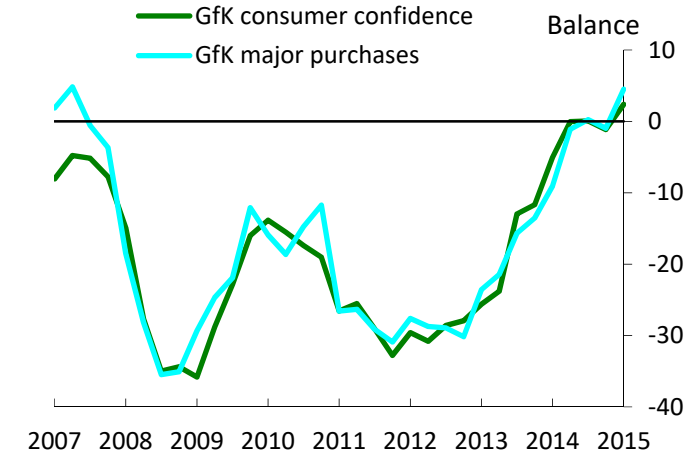


Chart 8: GfK consumer confidence



But lenders reported little boost to unsecured demand from relatively tighter conditions in some other credit markets

17. One other potential candidate explanation for the growth in consumer credit has been as a spillover from relatively tighter credit conditions in the mortgage or SME sector, although there is little evidence that this is occurring.

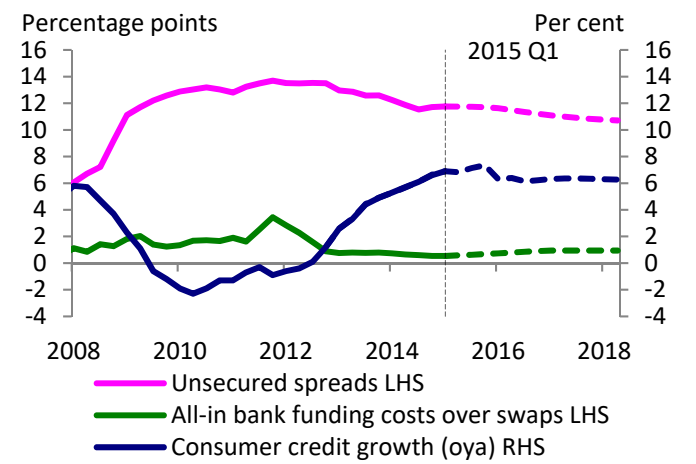
18. In April 2014, the Mortgage Market Review introduced more affordability rules for mortgage borrowers. This may have affected some borrowers' ability or perceived ability to gain or extend a mortgage. In addition, greater

LTV tiering in mortgage rates since the financial crisis has increased the marginal rate on extending a mortgage. As such, one hypothesis was that some mortgage borrowers may be choosing to use unsecured personal loans for home improvements and other purposes that might have used housing equity withdrawal in the past.

19. Moreover, it is possible that SMEs that want to borrow may have increasingly chosen to borrow using unsecured products. Growth in corporate lending has been negative for much of the period since 2012, with credit conditions for the smallest firms are still reported to be tight. The SME finance monitor reports than over 40% of firms with 0 employees use some borrowing facility in a personal name.

20. However, in discussions with the lenders as part of the BLMT round, they were unable to identify either of these trends and most thought they were unlikely to be occurring. There was no evidence that the proportion of borrowers citing home improvement as the reason for their personal loan had changed. Related to this, good credit quality borrowers who could access personal loan rates below 4% should also be able to access low mortgage rates. Generally lenders thought that borrowers viewed mortgage, unsecured and corporate credit as different products, with for example different terms, and so thought the substitutability between products would be limited.

Chart 9: Consumer credit, unsecured spreads and bank funding cost spreads



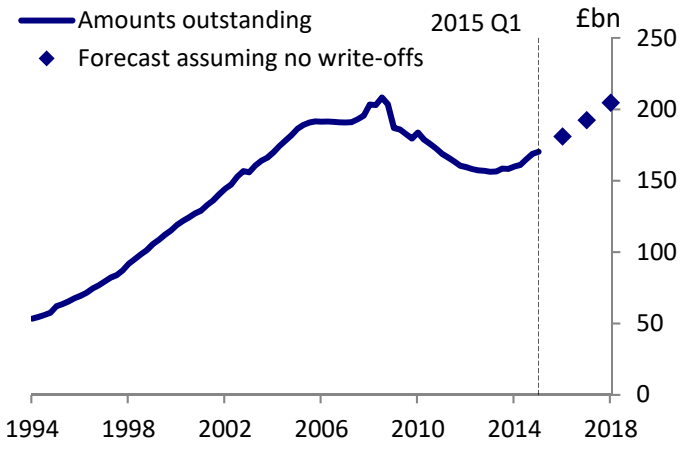
What is the outlook and risks over the forecast?

21. Over the past few years, we think that demand, but particularly supply, factors have been important drivers in the pickup in consumer credit growth.

Consumer credit growth remains robust as spreads fall slightly and bank funding costs remain subdued

22. Over the forecast, we judge that unsecured spreads will fall slightly further as bank funding costs remain subdued (Chart 9). Therefore, the more supportive supply environment for consumer credit should persist and may even get slightly better. Consumer credit demand should also stay robust as nominal consumption continues to grow and unemployment falls slightly over the forecast. As such, our forecast is for consumer credit to continue to grow at around 6% per year (Chart 9). Most lenders also expected continued growth in consumer credit in 2015.

Chart 10: Amounts outstanding on consumer credit



But the amounts of consumer credit outstanding should continue to remain below their peak

23. Despite the recent growth in consumer credit the amounts outstanding is only currently at 2004 levels due to large write-offs made between 2006 and 2011. And our forecast for robust consumer credit growth would take the amounts outstanding in 2018 back just below its peak level (Chart 10). Although this forecast assumes that there are no write-offs. Write-offs on consumer credit were £3.0bn in 2013 and £2.5bn in 2014.

One significant risk to credit conditions generally would be an increase in bank funding costs

24. The single largest risk to the outlook for credit spreads remains the possibility than an adverse global development is transmitted to banks' wholesale funding spreads. Upside risks to bank funding costs were judged to have increased slightly during the May 2015 forecast round, on account of the situation in Greece (for more details). If there was an adverse shock to bank funding costs, a contraction in consumer credit could play a significant role as a propagation mechanism.

Forthcoming regulatory changes could pose some downside risk to consumer credit growth

25. There are also risks to consumer credit supply, specifically. One of these comes from interchange fees – the fees charged by payment service providers. The European Parliament voted in March 2015 to introduce proposals for a cap on interchange fees of 30bps for credit card transactions and 20bps for debit card transactions[7], to be introduced later this year. Credit card interchange fees in the UK are estimated to be over 80bps currently whilst those on debit cards are estimated to be nearer 20bps[8].

26. As a result of these changes to interchange fees lenders will make less money from consumers simply using credit cards for purchases and so there is likely to be more focus on other ways to raise income. There are a number of possible ways lenders could respond. Speaking with lenders, most thought there would be a reduction in reward schemes and loyalty programmes, and lenders have already done this. But some lenders suggested than annual fees may be introduced or APRs could be increased to make up for lost revenue and any increase in APRs would be an upside risk to our unsecured credit spreads forecast.

27. If there are fewer incentives for consumers to make purchases on credit cards this may reduce credit card gross flows. But many customers using credit cards for purchases pay off their balance each month which does not affect net lending and therefore consumer credit growth. However, there could some slight impact on consumer credit growth if credit card users who don't pay off their balance each month also reduced their spending on credit cards.

28. The FCA are currently conducting a study into the credit card market, particularly how the industry works with those in difficult financial situations. Lenders, who commented on this in the BLMT calls, were generally unsure what the outcome and effect of this would be.

But risks from demand were judged in the May 15 *IR* to be broadly balanced

29. Household consumption was forecasted in the May 2015 *Inflation Report* to grow slightly below pre-crisis average rates over the forecast. There are risks around this in both directions, stemming from both real incomes and saving decisions. Unemployment is forecasted to fall slightly further in the central projection as slack is absorbed, and again risks are viewed as balanced. As such, the risks around the demand factors that have been boosting consumer credit growth recently, are judged to be broadly balanced over the forecast.

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[7] Multilateral interchange fees are agreed fees payable between the payment service providers of the payer/consumer and of the payee/merchant. When a consumer agrees a retail price it is the retail price minus the interchange fee that is transferred from the consumer's bank to the retailer's bank. The retailer's bank may charge additional fees (network fees, fees for other services) before placing the money into the retailer's account, but the interchange fee is the largest wedge between the retail price and the amount that goes into the retailer's account. The consumer's account in debited by the retail price. As such consumers pay the interchange fees indirectly in retail prices.

[8] These estimates are taken from the 2014 stress submissions), and the European Commission report (link).