DYNAM/C CREDIT

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Alternative Lending Market Update

Loan Issuance at 60% of 2010 levels, Underwriting Standards Tighter, Interest Income Higher

While uncertainty about broader macroeconomic conditions remains as we enter month five of the COVID-19 pandemic, in the consumer loan space interest income is increasing at the same time loan underwriting standards are tightening. Prime and super-prime consumer loans as whole has thus far performed well relative to both expectations as well as other consumer asset classes.

To be clear, with the number of COVID-19 cases passing 13 million worldwide, the world continues to adjust to life with the pandemic in the background for the foreseeable future. While Western Europe and parts of Asia continue to progress to a semblance of normalcy, we continue to see an acceleration in the number of daily new cases in many areas like (Latin) America, Eastern Europe and India. This aligns with the easing in lockdown measures we continue to see across Europe at the beginning of July as some countries have now opened external borders. However, the macroeconomic picture remains difficult as ECB President Lagarde described expectations of a complicated economic recovery using the words “sequential and restrained.” This aligns with our continuing view that the global recovery will be halting and uneven, with potentially a very long path towards pre-pandemic levels of economic activity. In the United States, new COVID-19 epicenters such as Florida have raised concerns about a return to lockdown measures, but for better or worse, the United States is unlikely to close the economy again and will serve as a test case for life and commerce in a current pandemic economy. While much uncertainty remains about the exact shape the recovery will take, mortality rates remain relatively low compared to earlier in the pandemic. At the same time, promising new developments in treatments and potential vaccines offer reasons to be optimistic that people will be willing and able to resume normal activities on a broader scale.

On the monetary policy side, while the ECB has increased the Pandemic Emergency Purchase Program (PEPP) up to EUR 1.35 trillion, the European policy response remains muted compared to the response by the US Federal Reserve which has signaled effectively unlimited resources to counter the effects of an economic slowdown. While progress on additional fiscal policy measures have stalled since the unprecedented CARES stimulus package was passed at the end of March (along with numerous state and local measures to alleviate financial stress on households), it remains likely that another, albeit smaller, stimulus package will be passed before the August Senate recess. Despite on the ongoing turmoil to economic activity and the resulting sharp increases in unemployment in April, the weight of the US monetary and fiscal policy response combined with continued economic reopening in the face of rising COVID-19 cases (for better or worse) has resulted in unexpected strength in both the stock market as well unemployment rates. The S&P 500 has retraced much of the losses from March and is now about flat for the year (while the NASDAQ is at record highs) while both U-3 (the official unemployment rate) and U-6 (which measures underemployment as well) have declined significantly to 11.1% and 18.0% in June, respectively, from 14.7% and 22.8%, respectively, in April.

While unemployment remains above the March U-3 and U-6 rates of 4.4% and 8.7%, respectively, US consumer loans as a whole have performed well in relative terms with loan impairment rates rising about 10 points from about 6% in March to a peak of about 16.5% in April, in line with the change in unemployment rates. This is in line with the over 8 points increase of US mortgages in forbearance over the same period and is, in part, because US consumers entered this crisis with 5% less household debt, but almost 10% more income when compared to the financial crisis. Since April, the overall impairment rate has fallen by about 15%, but underlying improvement has been even better as over 40% of modified loans have resumed making at least partial payments. The improvement in the higher quality loan grades has been even stronger as 40% of modified loans are back to making full payments.

Loan issuance has remained muted at about 60% below 2019 levels as underwriting criteria has gotten considerably tighter and borrowers have become more conservative in taking on new debt. While banks and credit unions remain significant buyers of consumer loans due to attractive net interest margins, most of the decline has come from leveraged buyers as well as securitization activities due to the cost of financing. While spreads have tightened in significantly since March, a recovery in origination volumes will depend on the continued strong performance of loans through the second half of 2020

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